

As 1**Illustration 1**

ABC Ltd. was making provision for non-moving inventories based on no issues for the last 12 months up to 31.3.2012.

The company wants to provide during the year ending 31.3.2013 based on technical evaluation:

<i>Total value of inventory</i>	<i>₹ 100 lakhs</i>
<i>Provision required based on 12 months issue</i>	<i>₹ 3.5 lakhs</i>
<i>Provision required based on technical evaluation</i>	<i>₹ 2.5 lakhs</i>

Does this amount to change in Accounting Policy? Can the company change the method of provision?

Solution

The decision of making provision for non-moving inventories on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving inventories should be made. The method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2012-13:

"The company has provided for non-moving inventories on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been higher by ₹ 1 lakh."

Illustration 2

Jagannath Ltd. had made a rights issue of shares in 2011. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2013. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following :

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

- (ii) *Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at ₹ 27 crores is lower than the amount of ₹ 45 crores which would have been provided had the old method been followed, by ₹ 18 cores.*
- (iii) *Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.*
- (iv) *Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being ₹ 10 crores.*

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2012-2013.

Solution

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

Notes on Accounts:

- (i) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ₹ 50 crores and the profit for the year is increased by ₹ 20 crores.
- (ii) In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at ₹ 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by ₹ 18 crores. To that extent, the profit for the year is increased.
- (iii) So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 12 crores than would have been the case if the old policy were to continue.
- (iv) The company has decided to provide ₹ 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹ 10 crores.

Illustration 1

A Ltd. purchased 1,00,000 MT for ₹ 100 each MT of raw material and introduced it in the production process and get 85,000 MT as output. Normal wastage is 5%. In the process, company incurred the following expenses:

<i>Direct Labour</i>	<i>₹ 10,00,000</i>
<i>Direct Variable Overheads</i>	<i>₹ 1,00,000</i>
<i>Direct Fixed Overheads</i>	<i>₹ 1,00,000</i>
<i>(Including interest ₹ 40,625)</i>	

Of the above 80,000 MT was sold during the year and remaining 5,000 MT remained in closing inventory. Due to fall in demand in market the selling price for the finished goods on the closing day was estimated to be ₹ 105 per MT. Calculate the value of closing inventory.

Solution**Calculation of cost for closing inventory**

<i>Particulars</i>	<i>₹</i>
Cost of Purchase (1,00,000 x 100)	1,00,00,000
Direct Labour	10,00,000
Variable Overhead	1,00,000
Fixed Overhead $\frac{(1,00,000 - 40,625) \times 85,000}{95,000}$	<u>53,125</u>
Cost of Production	<u>1,11,53,125</u>
Cost of closing inventory per unit (1,11,53,125/85,000)	₹ 131 (approx)
Net Realisable Value per unit	₹ 105

Since, net realisable value is less than cost, closing inventory will be valued at ₹ 105. Therefore, closing inventory is ₹ 5,25,000 (5,000 x 105).

Illustration 2

In a manufacturing process of Vijoy Limited, one by-product BP emerges besides two main products MP1 and MP2 apart from scrap. Details of cost of production process is here under:

<i>Item</i>	<i>Unit</i>	<i>Amount (₹)</i>	<i>Output (unit)</i>	<i>Closing inventory as on 31-03-2012</i>
<i>Raw material</i>	<i>15,000</i>	<i>1,60,000</i>	<i>MP1-6,250</i>	<i>800</i>
<i>Wages</i>	<i>-</i>	<i>82,000</i>	<i>MP2- 5,000</i>	<i>200</i>
<i>Fixed overhead</i>	<i>-</i>	<i>58,000</i>	<i>BP-1,600</i>	<i>-</i>
<i>Variable overhead</i>	<i>-</i>	<i>40,000</i>	<i>-</i>	<i>-</i>

Average market price of MP1 and MP2 is ₹ 80 per unit and ₹ 50 per unit respectively, by-product is sold @ ₹ 25 per unit. There is a profit of ₹ 5,000 on sale of by-product after incurring separate processing charges of ₹ 4,000 and packing charges of ₹ 6,000, ₹ 6,000 was realised from sale of scrap.

Calculate the value of closing inventory of MP1 and MP2 as on 31-03-2012.

Solution

As per para 10 of AS 2 'Valuation of Inventories', most by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realizable value and this value is deducted from the cost of the main product.

1. Calculation of net realizable value of by-product, BP

		₹
Selling price of by-product BP	(1,600 units x ₹ 25 per unit)	40,000
Less: Separate processing charges of by-product BP		(4,000)
Packing charges		<u>(6,000)</u>
Net realizable value of by-product BP		<u>30,000</u>

2. Calculation of cost of conversion for allocation between joint products MP1 and MP2

	₹	₹
Raw material		1,60,000
Wages		82,000
Fixed overhead		58,000
Variable overhead		<u>40,000</u>
		3,40,000
Less: NRV of by-product BP (See calculation 1)	(30,000)	
Sale value of scrap	<u>(6,000)</u>	<u>(36,000)</u>
Joint cost to be allocated between MP1 and MP2		<u>3,04,000</u>

3. Determination of "basis for allocation" and allocation of joint cost to MP1 and MP2

	MP1	MP2
Output in units (a)	6,250 units	5,000 units
Sales price per unit (b)	₹ 80	₹ 50
Sales value (a x b)	₹ 5,00,000	₹ 2,50,000
Ratio of allocation	2	1
Joint cost of ₹ 3,04,000 allocated in the ratio of 2:1 (c)	₹ 2,02,667	₹ 1,01,333
Cost per unit [c/a]	₹ 32.43	₹ 20.27

4. Determination of value of closing inventory of MP1 and MP2

	MP1	MP2
Closing inventory in units	800 units	200 units
Cost per unit	₹ 32.43	₹ 20.27
Value of closing inventory	₹ 25,944	₹ 4,054

Illustration 3

Ambica Stores is a departmental store, which sell goods on retail basis. It makes a gross profit of 20% on net sales. The following figures for the year-end are available:

Opening Inventory ₹ 50,000; Purchases ₹ 3,60,000; Purchase Returns ₹ 10,000; Freight Inwards ₹ 10,000; Gross Sales ₹ 4,50,000; Sales Returns ₹ 11,250; Carriage Outwards ₹ 5,000.

Compute the estimated cost of the inventory on the closing date.

Solution**Calculation of cost of closing inventory**

Particulars	₹
Opening Inventory	50,000
Purchases less returns (₹ 3,60,000 – ₹ 10,000)	3,50,000
Freight Inwards	<u>10,000</u>
	4,10,000
Less: Net Sales (₹ 4,50,000 – ₹ 11,250)	<u>(4,38,750)</u>
	(28,750)
Add: Gross Profits (₹ 4,38,750 x 20%)	<u>87,750</u>
Closing Inventory	<u>59,000</u>

Illustration 4

<i>Particulars</i>		<i>Kg.</i>	<i>₹</i>
<i>Opening Inventory:</i>	<i>Finished Goods</i>	1,000	25,000
	<i>Raw Materials</i>	1,100	11,000
<i>Purchases</i>		10,000	1,00,000
<i>Labour</i>			76,500
<i>Overheads (Fixed)</i>			75,000
<i>Sales</i>		10,000	2,80,000
<i>Closing Inventory:</i>	<i>Raw Materials</i>	900	
	<i>Finished Goods</i>	1200	

The expected production for the year was 15,000 kg of the finished product. Due to fall in market demand the sales price for the finished goods was ₹ 20 per kg and the replacement cost for the raw material was ₹ 9.50 per kg on the closing day. You are required to calculate the closing inventory as on that date.

Solution**Calculation of cost for closing inventory**

<i>Particulars</i>	<i>₹</i>
Cost of Purchase (10,200 x 10)	1,02,000
Direct Labour	76,500
Fixed Overhead $\frac{75,000 \times 10,200}{15,000}$	<u>51,000</u>

Cost of Production	<u>2,29,500</u>
Cost of closing inventory per unit (2,29,500/10,200)	₹ 22.50
Net Realisable Value per unit	₹ 20.00

Since net realisable value is less than cost, closing inventory will be valued at ₹ 20.

As NRV of the finished goods is less than its cost, relevant raw materials will be valued at replacement cost i.e. ₹ 9.50.

Therefore, value of closing inventory: Finished Goods (1,200 x 20)	₹ 24,000
Raw Materials (900 x 9.50)	<u>₹ 8,550</u>
	<u>₹ 32,550</u>

Illustration 5

The closing inventory at cost of a company amounted to ₹ 2,84,700. The following items were included at cost in the total:

- (a) 400 coats, which had cost ₹ 80 each and normally sold for ₹ 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.
- (b) 800 skirts, which had cost ₹ 20 each. These too were found to be defective. Remedial work in April cost ₹ 5 per skirt, and selling expenses for the batch totaled ₹ 800. They were sold for ₹ 28 each.

What should the inventory value be according to AS 2 after considering the above items?

Solution**Valuation of Closing Inventory**

Particulars	₹	₹
Closing Inventory at cost		2,84,700
Less : Cost of 400 coats (400 x 80)	32,000	
Less: Net Realisable Value [(400 x 75) – (5% of Rs.75) x 400]	<u>28,500</u>	<u>3,500</u>
Value of Closing Inventory		<u>2,81,200</u>

Illustration 6

State with reference to accounting standard, how will you value the inventories in the following cases:

- (i) Raw material was purchased at ₹ 100 per kilo. Price of raw material is on the decline. The finished goods in which the raw material is incorporated is expected to be sold at below cost. 10,000 kgs. of raw material is on inventory at the year end. Replacement cost is ₹ 80 per kg.
- (ii) In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is ₹ 1,000. The entire quantity of waste is on inventory at the year end.
- (iii) Per kg. of finished goods consisted of:

Material cost	₹ 100 per kg
Direct labour cost	₹ 20 per kg.
Direct variable production overhead	₹ 10 per kg.

Fixed production charges for the year on normal capacity of one lakh kgs. is ₹ 10 lakhs. 2,000 kgs. of finished goods are on inventory at the year end.

Solution

- (a) (i) As per para 24 of AS 2 (Revised) on 'Valuation of Inventories', materials and other supplies held for use in the production of inventories are not written down below cost if the finished product in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

Hence, in the given case, the inventory of 10,000 kgs of raw material will be valued at ₹ 80 per kg. The finished goods, if on inventory, should be valued at net realisable value since it is expected to be sold below cost.

- (ii) As per para 13 of AS 2 (Revised), abnormal amounts of waste materials, labour or other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred.

In this case, normal waste is 250 MT and abnormal waste is 50 MT.

The cost of 250 MT will be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste amounting to ₹ 52,632 [(50 MT x (₹ 50,00,000 / 4,750 MT))] will be charged in the statement of profit and loss.

- (iii) In accordance with paras 8 and 9 of AS 2 (Revised), the costs of conversion include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Thus, cost per kg. of finished goods can be computed as follows:

	₹
Material cost	100
Direct labour cost	20
Direct variable production overhead	10
Fixed production overhead $\left(\frac{₹ 10,00,000}{1,00,000} \right)$	<u>10</u>
	<u>140</u>

Thus, the value of 2,000 kgs of finished goods on inventory at the year end will be ₹ 2,80,000 (2,000 kgs. x ₹ 140).

Illustration 7

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2012-13, the historical cost and net realizable value of the items of closing inventory are determined as follows:

<i>Items</i>	<i>Historical Cost (₹ in lakhs)</i>	<i>Net Realisable Value (₹ in lakhs)</i>
<i>A</i>	<i>40</i>	<i>28</i>
<i>B</i>	<i>32</i>	<i>32</i>
<i>C</i>	<i>16</i>	<i>24</i>

What will be the value of closing inventory?

Solution:

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

<i>Items</i>	<i>Historical Cost (₹ in lakhs)</i>	<i>Net Realisable Value (₹ in lakhs)</i>	<i>Valuation of closing inventory (₹ in lakhs)</i>
<i>A</i>	<i>40</i>	<i>28</i>	<i>28</i>
<i>B</i>	<i>32</i>	<i>32</i>	<i>32</i>
<i>C</i>	<u><i>16</i></u>	<u><i>24</i></u>	<u><i>16</i></u>
	<u><i>88</i></u>	<u><i>84</i></u>	<u><i>76</i></u>

Hence, closing inventory will be valued at ₹ 76 lakhs.

As 4

Illustration 1

Pure Oil Ltd. closed the books of accounts on March 31, 2012 for which financial statement was finalized by the Board of Directors on September 04, 2012. During the month of December 2011, company undertook the project of laying a pipeline across the country and during May 2012 engineers realized that due to unexpected heavy rain, the total cost of the project will be inflated by ₹ 50 lakhs. How this should be provided for in the balance sheet of 2011-12 in accordance to AS 4?

Solution

This event occurred after March 31, 2012 but before September 04, 2012 is an event occurring after the balance sheet date. But this event is not affecting financial position on the date of balance sheet therefore it should be disclosed in the directors report.

Illustration 2

In preparing the financial statements of R Ltd. for the year ended 31st March, 2012, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2012 in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Solution

Para 3.2 of AS 4 (Revised) defines "Events Occurring after the Balance Sheet Date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Approving Authority in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2012. Applying para 15 which clearly states that disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 100 lakhs in April, 2012 in the acquisition of another company should be disclosed in the report of the Approving Authority to enable users of financial statements to make proper evaluations and decisions.

Illustration 3

A Limited Company closed its accounting year on 30.6.2012 and the accounts for that period were considered and approved by the board of directors on 20th August, 2012. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2012 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.2012.

Solution

Para 3.2 of AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above mentioned definition and requirements given in paras 13-15 of the said AS 4 (Revised).

In this case the incidence, which was expected to push up cost, became evident after the date of approval of the accounts. So that was not an 'event occurring after the balance sheet date'. However, this may be mentioned in the Report of Approving Authority.

Illustration 4

While preparing its final accounts for the year ended 31st March, 2012 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 2012 a trade receivable for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance

policy. In April, 2012 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 2012?

Solution

As per paras 8.2 and 13 of Accounting Standard 4 on Contingencies and Events Occurring after the Balance Sheet Date, Assets and Liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 2012. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 2012, then mere disclosure required as per para 15, would have been sufficient.

As 5

Illustration 1

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 2007 to September, 2011 has been received and paid in February, 2012.

Solution

The final bill having been paid in February, 2012 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2012. However it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2012, this material charge has arisen in the current period i.e., year ended 31st March, 2013. Therefore it should be treated as 'Prior period item' as per para 16 of AS 5. As per para 19 of AS 5 (Revised), prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per Para 10 of AS 5 (Revised). For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.

Illustration 2

There was a major theft of stores valued at ₹ 10 lakhs in the preceding year which was detected only during current financial year (2011-2012). How will you deal with this information in preparing the financial statements of R Ltd. for the year ended 31st March, 2012.

Solution

Due to major theft of stores in the preceding year (2010-2011) which was detected only during the current financial year (2011-2012), there was overstatement of closing inventory of stores in the preceding year. This must have also resulted in the overstatement of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year as 'Prior Period Items' as per AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. Accordingly, the adjustments relating to both opening inventory of the current year and profit brought forward from the previous year should be separately disclosed in the statement of profit and loss together with their nature and amount in a manner that their impact on the current profit or loss can be perceived.

Note: Alternatively, it may be assumed that in the preceding year, the value of inventory of stores as found out by physical verification of inventories was considered in the preparation of financial statements of the preceding year. In such a case, only the disclosure as to the theft and the resulting loss is required in the notes to the accounts for the current year i.e, year ended 31st March, 2012.

Illustration 3

- (i) During the year 2011-2012, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?*
- (ii) A Limited company has been including interest in the valuation of closing inventory. In 2011-2012 the management of the company decided to follow AS 2 and accordingly interest has been excluded from the valuation of closing inventory. This has resulted in a decrease in profits by ₹ 3,00,000. Is a disclosure necessary? If so, draft the same.*
- (iii) A company signed an agreement with the Employees Union on 1.9.2011 for revision of wages with retrospective effect from 30.9.2010. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2011-12?*

Solution

- (i) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Para 12 of AS 5 (Revised in 1997) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies states that:

"When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately."

Circumstances which may give to separate disclosure of items of income and expense in accordance with para 12 of AS 5 include the write-down of inventories to net realisable value as

well as the reversal of such write-downs.

- (ii) As per AS 5 (Revised), change in accounting policy can be made for many reasons, one of these is for compliance with an accounting standard. In the instant case, the company has changed its accounting policy in order to conform with the AS 2 (Revised) on Valuation of Inventories. Therefore, a disclosure is necessary in the following lines by way of notes to the annual accounts for the year 2011-2012.

"To be in conformity with the Accounting Standard on Valuation of Inventories issued by ICAI, interest has been excluded from the valuation of closing stock unlike preceding years. Had the same principle been followed in previous years, profit for the year and its corresponding effect on the year end net assets would have been higher by ₹ 3,00,000."

- (iii) It is given that revision of wages took place on 1st September, 2011 with retrospective effect from 30.9.2010. Therefore wages payable for the half year from 1.10.2011 to 31.3.2012 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item.

Additional wages liability of ₹ 7,50,000 (for 1½ years @ ₹ 5,00,000 per annum) should be included in current year's wages.

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

Illustration 4

While preparing its final accounts for the year ended 31st March, 2012 Rainbow Limited created a provision for Bad and Doubtful debts at 2% on trade receivables. A few weeks later the company found that payments from some of the major trade receivables were not forthcoming. Consequently the company decided to increase the provision by 10% on the trade receivables as on 31st March, 2012 as the accounts were still open awaiting approval of the Board of Directors. Is this to be considered as an extra-ordinary item or prior period item? Comment.

Solution

The preparation of financial statements involves making estimates which are based on the circumstances existing at the time when the financial statements are prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate does not bring the resulting amount within the definition either of prior period item or of an extraordinary item [para 21, AS 5 (Revised)].

In the given case, Rainbow Limited created a provision for bad and doubtful debts at 2% on trade receivables while preparing its final accounts for the year ended 31st March, 2012. Subsequently, the company decided to increase the provision by 10%. As per AS 5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.

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

Illustration 5

The company finds that the inventory sheets of 31.3.2011 did not include two pages containing details of inventory worth ₹ 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 2012.

Solution

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

Rectification of error in inventory valuation is a prior period item vide Para 4 of AS 5. ₹14.5 lakhs must be added to the opening inventory of 1.4.2011. It is also necessary to show ₹ 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

As 6**Illustration 2**

Mr. A purchased a machine on 01.04.2007 for ₹ 1,00,000. On 01.07.2008 he purchased another machine for ₹ 1,50,000. On 01.10.2009, he purchased the third machine for ₹ 2,00,000 and on 31.12.2010 he sold the second machine for ₹ 1,25,000. On 31.03.2012 he decided to change the method of charging depreciation from Straight Line Method @ 10% p.a. to Written Down Value Method @ 15%.

Solution

Working Note 1: Depreciation charged under old method:

Particulars	₹	₹
Purchase of first machine	1,00,000	
Depreciation for 4 years (1,00,000 x 10% x 4)		40,000
Purchase of third machine	2,00,000	
Depreciation for 1.5 years (2,00,000 x 10% x 1.5)		30,000
Total Depreciation charged		70,000

Working Note 2: Depreciation to be charged under new method:

Year	Opening WDV ₹	Purchases ₹	Balance ₹	Depreciation ₹	Closing WDV ₹
2007-08	---	1,00,000	1,00,000	15,000	85,000
2008-09	85,000	---	85,000	12,750	72,250
2009-10	72,250	2,00,000	2,72,250	40,838	2,31,412
2010-11	2,31,412	---	2,31,412	34,712	1,96,700
		Total Depreciation		1,03,300	

Machine Account

Date	Particulars	₹	Date	Particulars	₹
01.04.2007	To Bank	1,00,000	31.03.2008	By Depreciation	10,000
				By Balance c/d	90,000
		1,00,000			1,00,000
01.04.2008	To Balance b/d	90,000	31.03.2009	By Depreciation	21,250
01.07.2008	To Bank	1,50,000		By Balance c/d	2,18,750
		2,40,000			2,40,000

01.04.2009	To Balance b/d	2,18,750	31.03.2010	By Depreciation	35,000
01.10.2009	To Bank	2,00,000		By Balance c/d	3,83,750
		4,18,750			4,18,750
01.04.2010	To Balance b/d	383,750	31.12.2010	By Bank	125,000
31.12.2010	To Profit on Sale	12,500	31.03.2011	By Depreciation	41,250
		3,96,250		By Balance c/d	2,30,000
01.04.2011	To Balance b/d	2,30,000	31.03.2012	By Profit & Loss A/c.	33,300
				By Depreciation (1,96,700 x 15%)	29,505
		2,30,000		By Balance c/d	1,67,195
01.04.2012	To Balance b/d	1,67,195			2,30,000

Illustration 1

Mr. X set up a new factory in the backward area and purchased plant for ₹ 500 lakhs for the purpose. Purchases were entitled for the CENVAT credit of ₹ 10 lakhs and also Government agreed to extend the 25% subsidy for backward area development. Determine the depreciable value for the asset.

Solution

Particulars	₹ (in lakhs)
Cost of the plant	500
Less: CENVAT	<u>(10)</u>
	490
Less: Subsidy (490 x 25%)	<u>(122.50)</u>
Depreciable Value	<u>367.50</u>

As 7**Illustration 1**

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2012.

	(₹ in lakhs)
Total Contract Price	1,000
Work Certified	500
Work not Certified	105
Estimated further Cost to Completion	495
Progress Payment Received	400
To be Received	140

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 (Revised) issued by your institute.

Solution

(a)	Amount of foreseeable loss	(₹ in lakhs)
	Total cost of construction (500 + 105 + 495)	1,100
	Less: Total contract price	<u>(1,000)</u>
	Total foreseeable loss to be recognized as expense	<u>100</u>

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

(b)	Contract work-in-progress i.e. cost incurred to date are ₹ 605 lakhs	(₹ in lakhs)
	Work certified	500
	Work not certified	<u>105</u>
		<u>605</u>

This is 55% ($605/1,100 \times 100$) of total costs of construction.

- (c) Proportion of total contract value recognised as revenue as per para 21 of AS 7 (Revised).

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

- (d) Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)
 = [605 + Nil – 100 – (400 + 140)] ₹ in lakhs
 = [605 – 100 – 540] ₹ in lakhs

Amount due to customers = ₹ 35 lakhs

The amount of ₹ 35 lakhs will be shown in the balance sheet as liability.

- (e) The relevant disclosures under AS 7 (Revised) are given below:

	₹ in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognized losses	(100)
Progress billings ₹ (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

Illustration 2

On 1st December, 2011, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2012, the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2012 as per provisions of Accounting Standard 7 (Revised)?

Solution

(a)	₹
Cost incurred till 31 st March, 2012	64,99,000
Prudent estimate of additional cost for completion	<u>32,01,000</u>
Total cost of construction	97,00,000
Less: Contract price	<u>(85,00,000)</u>
Total foreseeable loss	<u>12,00,000</u>

According to para 35 of AS 7 (Revised 2002), the amount of ₹ 12,00,000 is required to be recognized as an expense.

$$\text{Contract work in progress} = \frac{\text{₹ } 64,99,000 \times 100}{97,00,000} = 67\%$$

Proportion of total contract value recognized as turnover as per para 21 of AS 7 (Revised) on Construction Contracts.

$$= 67\% \text{ of ₹ } 85,00,000 = \text{₹ } 56,95,000.$$

As9**Illustration 1**

The stages of production and sale of a producer are as follows (all in Rupees):

Stage	Activity	Costs to date	Net Realisable Value
A	Raw Materials	10,000	8,000
B	WIP 1	12,000	13,000

C	WIP 2	15,000	19,000
D	Finished Product	17,000	30,000
E	Ready for Sale	17,000	30,000
F	Sale Agreed	17,000	30,000
G	Delivered	18,000	30,000

State and explain the stage at which you think revenue will be recognized and how much would be gross profit and net profit on a unit of this product?

Solution

According to AS 9, sales will be recognized only following two conditions are satisfied:

- (i) The sale value is fixed and determinable.
- (ii) Property of the goods is transferred to the customer.

Both these conditions are satisfied only at Stage F when sales are agreed upon at a price and goods allocated for delivery purpose.

Gross Profit will be determined at Stage E, when goods are ready for sale after all necessary process for production is over i.e. ₹ 13,000 (30,000 – 17,000).

Net Profit will be determined at Stage G, when goods are delivered and payment becomes due ₹ 12,000 (30,000 – 18,000).

Illustration 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2012. The details are given below:

<i>Quantity of Gold</i>	<i>=</i>	<i>10,000 TT Bars</i>
<i>Gold Rate as on March 31, 2012</i>	<i>=</i>	<i>₹ 275 per TT Bar</i>
<i>Gold Rate was fixed on June 26, 2012 before the finalization of accounts of company</i>	<i>=</i>	<i>₹ 273 per TT Bar</i>

Calculate the amount of sales regarding 10,000 TT Bars to be booked in the company's account for the year ended March 31, 2012.

Solution

We need to refer to AS 5 along with AS 9 in this case, since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at ₹ 273 per TT Bar, gold will be valued at that rate.

Illustration 3

The Board of Directors decided on 31.3.2012 to increase the sale price of certain items retrospectively from 1st January, 2012. In view of this price revision with effect from 1st January 2012, the company has to receive ₹ 15 lakhs from its customers in respect of sales

made from 1st January, 2012 to 31st March, 201 and the Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2011-2012.

Solution

Price revision was effected during the current accounting period 2011-2012. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2012 to 31st March, 2012. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2011-2012 vide Para 10 of AS 9.

Illustration 4

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2011-12. You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution

As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

- (i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.
- (ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 5

A claim lodged with the Railways in March, 2010 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 2012 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2012.

Solution

Prudence suggests non-consideration of claim as an asset in anticipation. So receipt of claims is generally recognised on cash basis. Para 9.2 of AS 9 on Revenue Recognition states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. Para 9.5 of AS 9 states that when recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only ₹ 1,50,000 were collected against a claim of ₹ 2,00,000. So this transaction can not be taken as a Prior Period Item.

In the light of revised AS 5, it will not be treated as extraordinary item. However, para 12 of AS 5 (Revised) states that when items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Accordingly, the nature and amount of this item should be disclosed separately as per para 12 of AS 5 (Revised).

Illustration 6

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2011-2012 the company wants to recognise the entire interest receivable. Do you agree?

Solution

As per para 9.2 of AS 9 on Revenue Recognition, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

Thus, SCL Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstandings is also an estimate and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

Illustration 7

A Ltd. has sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31st March, 2012, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

Solution

The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. A Ltd. should record the sale and recognize the profit of ₹ 20 lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

As 10**Illustration 1**

ABC Ltd. is constructing a fixed asset. Following are the expenses incurred on the construction:

	₹
<i>Materials</i>	<i>10,00,000</i>
<i>Direct Expenses</i>	<i>2,50,000</i>
<i>Total Direct Labour</i>	<i>5,00,000</i>
<i>(1/10th of the total labour time was chargeable to the construction)</i>	
<i>Total office & administrative expenses</i>	<i>8,00,000</i>
<i>(5% is chargeable to the construction)</i>	
<i>Depreciation on the assets used for the construction of this assets</i>	<i>10,000</i>

Calculate the cost of fixed assets.

Solution**Calculation of the cost of construction of Assets**

<i>Particulars</i>	₹
Direct Materials	10,00,000
Direct Labour	50,000
Direct Expenses	2,50,000
Office & Administrative Expenses	40,000
Depreciation	10,000
Cost of the Asset	13,50,000

Illustration 2

On March 01, 2012, X Ltd. purchased ₹ 5 lakhs worth of land for a factory site. Company demolished an old building on the property and sold the material for ₹ 10,000. Company incurred additional cost and realized salvaged proceeds during the March 2012 as follows:

<i>Legal fees for purchase contract and recording ownership</i>	<i>₹ 25,000</i>
<i>Title guarantee insurance</i>	<i>₹ 10,000</i>
<i>Cost for demolition of building</i>	<i>₹ 50,000</i>

Compute the balance to be shown in the land account on March 31, 2012 balance sheet.

Solution**Calculation of the cost for Purchase of Land**

<i>Particulars</i>	<i>₹</i>
Cost of Land	5,00,000
Legal Fees	25,000
Title Insurance	10,000
Cost of Demolition	50,000
Less: Salvage value of Material	<u>(10,000)</u>
Cost of the Asset	<u>5,75,000</u>

Illustration 3

J Ltd. purchased machinery from K Ltd. on 30.09.2011. The price was ₹ 370.44 lakhs after charging 8% Sales-tax and giving a trade discount of 2% on the quoted price. Transport charges were 0.25% on the quoted price and installation charges come to 1% on the quoted price.

A loan of ₹ 300 lakhs was taken from the bank on which interest at 15% per annum was to be paid.

Expenditure incurred on the trial run was Materials ₹ 35,000, Wages ₹ 25,000 and Overheads ₹ 15,000.

Machinery was ready for use on 1.12.2011. However, it was actually put to use only on 1.5.2012. Find

out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2011 to 1.5.2012. The entire loan amount remained unpaid on 1.5.2012.

Solution

(a)	₹ (in Lakhs)	(₹ in Lakhs)	
Quoted price (refer to working note)	350.00		
Less: 2% Trade Discount	<u>(7.00)</u>		
	343.00		
Add: 8% Sales tax (8% × ₹ 343 lakhs)	<u>27.44</u>	370.44	
Transport charges (0.25% × ₹ 350 lakhs)		0.88	(approx.)
Installation charges (1% × ₹ 350 lakhs)		3.50	
Financing cost (15% on ₹ 300 Lakhs) for the period 30.9.2011 to 1.12.2011		7.50	
Trial Run Expenses			
Material	0.35		
Wages	0.25		
Overheads	<u>0.15</u>	<u>0.75</u>	
Total cost		<u>383.07</u>	

Interest on loan for the period 1.12.2011 to 1.05.2012 is ₹ 300 lakhs $\times \frac{15}{100} \times \frac{5}{12}$
 = ₹ 18.75 lakhs

This expenditure may be charged to Profit and Loss Account or deferred for amortization between say three to five years. It has been assumed that no other expenses are incurred on the machine during this period.

Working Note:

Let the quoted price 'X'

Less: Trade Discount 0.02X.

Actual Price = 0.98X.

Sale Tax @8% = 1.08 × 0.98X

or $X = \frac{₹ 370.44 \text{ lakhs}}{1.08 \times 0.98} = ₹ 350 \text{ lakhs}$

As 11**Illustration 1**

Mr. A bought a forward contract for three months of US\$ 1,00,000 on 1st December at 1 US\$ = ₹ 47.10 when exchange rate was US\$ 1 = ₹ 47.02. On 31st December when he closed his books when exchange rate was US\$ 1 = ₹ 47.15. On 31st January, he decided to sell the contract at ₹ 47.18 per dollar. Show how the profits from contract will be recognized in the books.

Solution

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

Sale Rate	₹ 47.18
Less: Contract Rate	<u>(₹ 47.10)</u>
Premium on Contract	<u>₹ 0.08</u>
Contract Amount	US\$ 1,00,000
Total Profit (1,00,000 x 0.08)	₹ 8,000

Illustration 2

A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.2011 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 1.1.2011 and 31.12.2011 respectively. First instalment was paid on 31.12.2011. The entire difference in foreign exchange has been capitalized.

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

Solution

As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income or expense.

Calculation of Exchange Difference:

$$\text{Foreign currency loan} = \frac{\text{₹ 3,000 lakhs}}{\text{₹ 40}} = 75 \text{ lakhs US Dollars}$$

$$\begin{aligned} \text{Exchange difference} &= 75 \text{ lakhs US Dollars} \times (42.50 - 40.00) \\ &= \text{₹ 187.50 lakhs} \end{aligned}$$

(including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting ₹ 187.50 lakhs should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not exercised the option of capitalization available under para 46 of AS 11.

Illustration 3

Assets and liabilities and income and expenditure items in respect of foreign branches are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to revenue. Comment.

Solution

The financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures described in paragraphs 8 to 16 of AS 11 (Revised 2003). The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. For practical reasons, a rate that approximates the actual rate at the date of transaction is often used, for example, an average rate for a week or a month may be used for all transactions in each foreign currency during the period. The foreign currency monetary items (for example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account. Exchange difference arising on the translation of the financial statement of foreign operation may have tax effect which should be dealt as per AS 22 'Accounting for Taxes on Income'.

Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11 (Revised 2003).

Illustration 4

Option Ltd. is engaged in the manufacturing of steel. For its steel plant, it required machineries of latest technology. It usually resorts to Long Term Foreign Currency Borrowings for its fund requirements. On 1st April, 2011, it borrowed US \$1 million from International Funding Agency, USA when exchange rate was 1 \$ = ₹ 52. The funds were used for acquiring machineries on the same date to be used in three different steel plants. The useful life of the machineries is 10 years and their residual value is ₹ 20,00,000.

Earlier also the company used to purchase machineries out of foreign borrowings. The exchange differences arising on such borrowings were charged to profit and loss account and were not

capitalised even though the company had an option to capitalise it as per notified AS 11 (notification issued by the MCA in 2009).

Now for this new purchase of machinery, Option Ltd, is interested to avail the option of capitalising the same to the cost of asset. Exchange rate on 31st March, 2012 is 1 US \$ = ₹ 51. Assume that on 31st March, 2012, Option Ltd. is not having any old Long term foreign currency borrowings except for the amount borrowed for machinery purchased on 1st April, 2011.

Can Option Ltd. capitalise the exchange difference to the cost of asset on 31st March, 2012? If yes, then calculate the depreciation amount on machineries as on 31st March, 2012.

Would your answer differ, if Option Ltd. was not a company and was a LLP?

Solution

Ministry of Corporate Affairs, Government of India, inserted paragraph 46A in notified AS 11 by Notification dated 29th December, 2011, which is relevant for companies. It states that in respect of accounting periods commencing on or after 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 or not (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, though Option Ltd. had not earlier exercised the option as given by the notification on AS 11, issued in 2009, yet it can avail the option to capitalise the exchange difference to the cost of machinery by virtue of para 46A inserted in the notified AS 11 in December, 2011.

Exchange difference to be capitalised

Cost of the asset in \$		\$ 10 lakhs
Exchange rate on 1 st April, 2011		₹ 52 = 1\$
Cost of the asset in ₹	(\$ 10 lakhs x ₹ 52)	520 lakhs
Less: Exchange differences as on 31 st March, 2012 (52-51) x \$ 1 million	(Gain)	(10 lakhs)
		510 lakhs
Less: Depreciation for 2011-12	(510 lakhs - 20 lakhs)/10 years	(49 lakhs)
		<u>461 lakhs</u>

Notification number G.S.R 914(E), dated 29th December, 2011, is relevant only for companies. If Option Ltd. is a LLP, then this notification is not applicable and it can not capitalise the exchange difference to the cost of the machinery. The amount recognised to Profit and Loss account would be ₹ 10 lakhs.

As-12

Illustration 1

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

The company purchased on 01.04.2011 special purpose machinery for ₹ 25 lakhs. It received a Central Government Grant for 20% of the price. The machine has an effective life of 10 years.

Solution

AS 12 'Accounting for Government Grants' regards two methods of presentation, of grants related to specific fixed assets, in financial statements as acceptable alternatives. Under the first method, the grant can be shown as a deduction from the gross book value of the machinery in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

Under the second method, it can be treated as deferred income which should be recognised in the profit and loss statement over the useful life of 10 years in the proportions in which depreciation on machinery will be charged. The deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description e.g., 'Deferred government grants' to be shown after 'Reserves and Surplus' but before 'Secured Loans'.

The following should also be disclosed:

- (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 recognised in the financial statement of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 2

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of ₹ 50 crore in capital assets, received ₹ 10 crore from the Government in January, 2012 (accounting period being 2011-2012). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2012.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.

Solution

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to

revenue. Thus it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment followed by the company is not proper.

Illustration 3

On 1.4.2009, ABC Ltd. received Government grant of ₹ 300 lakhs for acquisition of a machinery costing ₹ 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 2012 due to non-fulfillment of certain conditions.

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

Solution

According to para 21 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing deferred income balance, as appropriate, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		₹ (in lakhs)
1st April, 2009	Acquisition cost of machinery (₹ 1,500 – ₹ 300)	1,200.00
31st March, 2010	Less: Depreciation @ 20%	<u>(240.00)</u>
	Book value	960.00
31st March, 2011	Less: Depreciation @ 20%	<u>(192.00)</u>
	Book value	768.00
31st March, 2012	Less: Depreciation @ 20%	<u>(153.60)</u>
1st April, 2012	Book value	614.40
May, 2012	Add: Refund of grant	<u>300.00</u>
	Revised book value	<u>914.40</u>

Depreciation @ 20% on the revised book value amounting ₹ 914.40 lakhs is to be provided prospectively over the residual useful life of the asset i.e. years ended 31st March, 2013 and 31st March, 2014.

Illustration 4

Yogya Ltd. received a specific grant of ₹ 300 lakhs for acquiring the plant of ₹ 1,500 lakhs during 2009-10 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet. During 2012-13, due to non-compliance of conditions laid down for the grant of ₹ 300 lakhs, the company had to refund the grant to the Government. Balance in the deferred income on that date was ₹ 210 lakhs and written down value of plant was ₹ 1,050 lakhs.

- (i) *What should be the treatment of the refund of the grant and the effect on cost of the fixed asset and the amount of depreciation to be charged during the year 2012-13 in the Statement of Profit and Loss?*

- (ii) *What should be the treatment of the refund if grant was deducted from the cost of the plant during 2009-10?*

Assume depreciation is charged on assets as per Straight Line Method.

Answer

As per para 21 of AS 12, amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

- (i) *In this case the grant refunded is ₹ 300 lakhs and balance in deferred income is ₹ 210 lakhs, therefore, ₹ 90 lakhs shall be charged to the profit and loss account for the year 2012-13. There will be no effect on the cost of the fixed asset and depreciation charge will be same as charged in the earlier years.*
- (ii) *As per para 21 of AS 12, the amount refundable in respect of grant which was related to specific fixed assets should be recorded by increasing the book value of the assets by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Therefore, in this case the book value of the plant shall be increased by ₹ 300 lakhs. The increased cost of ₹ 300 lakhs of the plant should be amortised over 7 years (residual life). Depreciation charged during the year 2012-13 shall be $1200/10 + 300/7 = ₹ 162.86$ lakhs.*

As-13

Illustration 1

An unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2012 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31st March, 2012?

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2012 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2012.

Illustration 2

X Ltd. invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.2012 to 31.3.2012), AS 13 lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realizable value of all such investments on 31.3.2012 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

Answer

As per AS 13, 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realizable value i.e. at ₹ 100 lakhs. The reduction of ₹ 200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Ltd. lost a case of copyright which drastically reduced the realisable value of its shares to one third which is quite a substantial figure. Losing the case of copyright may affect the business and the performance of the company in long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by ₹ 200 lakhs and show the investments at ₹ 100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of ₹ 200 lakhs in the carrying value of long term investment will be charged to the Statement of profit and loss.

As 15

Illustration 1

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards.

Solution

According to AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 2

As on 1st April, 2011 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 2011 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 2012 the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Acturial losses on the obligations for the year 2011-12 were ₹ 600.

On 1st April, 2011 the company made the following estimates, based on its market studies, understanding and prevailing prices.

	%
Interest & dividend income, after tax payable by the fund	9.25
Realised and unrealised gains on plan assets (after tax)	2.00
Fund administrative costs	<u>(1.00)</u>
Expected Rate of Return	<u>10.25</u>

You are required to find the expected and actual returns on plan assets.

Answer

Computation of Expected and Actual Returns on Plan Assets

	₹
Return on ₹ 1,00,000 held for 12 months at 10.25%	10,250
Return on ₹ 30,000 (49,000-19,000) held for six months at 5% (equivalent to 10.25% annually, compounded every six months)	<u>1,500</u>
Expected return on plan assets for 2011-12	<u>11,750</u>
Fair value of plan assets as on 31 March, 2012	1,50,000
Less: Fair value of plan assets as on 1 April, 2011	1,00,000
Contributions received	<u>49,000</u>
	<u>(1,49,000)</u>
	1,000
Add: Benefits paid	<u>19,000</u>
Actual return on plan assets	<u>20,000</u>

Illustration 3

Rock Star Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. In this, if the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Rock Star Ltd. estimates the share of unamortized service cost that relates to the part of the obligation at ₹ 18 (10% of ₹ 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

- Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.
- The fair value of plan assets on the date is estimated at ₹ 5,100.

(c) The unamortized past service cost is ₹ 180.

(d) Curtailment reduces the obligation by ₹ 600, which is 10% of the gross obligation.

Answer

Gain from curtailment is estimated as under:

	₹
Reduction in gross obligation	600
Less: Proportion of unamortised past service cost	(18)
Gain from curtailment	<u>582</u>

The liability to be recognised after curtailment in the balance sheet is estimated as under:

	₹
Reduced gross obligation (90% of ₹ 6,000)	5,400
Less: Fair value of plan assets	<u>(5,100)</u>
	300
Less: Unamortised past service cost (90% of ₹ 180)	<u>(162)</u>
Liability to be recognised in the balance sheet	<u>138</u>

As 16

Example

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 2X12, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 2X12, the exchange rate between the currencies was ₹45 per USD. The exchange rate, as at March 31, 2X13, is ₹48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 2X12.

Solution

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

- (i) Interest for the period = USD 10,000 x 5% x ₹ 48/USD = ₹ 24,000
- (ii) Increase in the liability towards the principal amount = USD 10,000 x (48-45) = ₹ 30,000
- (iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 x 45 x 11% = ₹ 49,500
- (iv) Difference between interest on local currency borrowing and foreign currency borrowing = ₹ 49,500 – ₹24,000 = ₹ 25,500

Therefore, out of ₹ 30,000 increase in the liability towards principal amount, only ₹ 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 49,500 being the aggregate of interest of ₹ 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 25,500.

Thus, ₹49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of ₹30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings (i.e., ₹ 34,500 (₹ 58,500 – ₹ 24,000)) is more than the exchange difference of ₹ 30,000. Therefore, in such a case, the total borrowing cost would be ₹ 54,000 (₹ 24,000 + ₹ 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11 'The Effects of Changes in Foreign Exchange Rates'.

Illustration 1

<i>Particulars</i>	<i>Amount (₹)</i>
<i>Expenditure incurred till 31-03-2011</i>	<i>7,00,000</i>
<i>Interest cost capitalized for the financial year 2010-11</i>	<i>30,000</i>
<i>Amount borrowed till 31-03-11 @ 15%</i>	<i>4,00,000</i>
<i>Amount transferred to construction during 2011-12</i>	<i>2,00,000</i>
<i>Cash payment during 2011-12 out of the above</i>	<i>1,00,000</i>
<i>Progress payment received</i>	<i>5,00,000</i>
<i>New borrowing during 2011-12 @ 15%</i>	<i>3,00,000</i>

Calculate the amount of borrowing to be capitalized.

Solution

Total Borrowing Cost = 7,00,000 X 0.15 = ₹ 1,05,000

<i>Particulars</i>	<i>Amount</i>
Expenditure incurred including previously capitalized borrowing cost	7,30,000
Cash payment during 2011-12 out of amount transferred	1,00,000
Remaining amount transferred during 2011-12	<u>1,00,000</u>
	9,30,000

Less: Progress payment received and recognised	5,00,000
Uncertified construction cost (not yet recognized)	4,30,000

Money borrowed including previously capitalized interest cost = ₹ 7,30,000

Borrowing cost to be capitalized = $4,30,000/7,30,000 \times 1,05,000$ = ₹ 61,849.32

Illustration 2

PRM Ltd. obtained a loan from a bank for ₹ 50 lakhs on 30-04-2011. It was utilized as follows:

Particulars	Amount (₹ in lakhs)
Construction of a shed	50
Purchase of a machinery	40
Working Capital	20
Advance for purchase of truck	10

Construction of shed was completed in March 2012. The machinery was installed on the same date. Delivery truck was not received. Total interest charged by the bank for the year ending 31-03-2012 was ₹ 18 lakhs. Show the treatment of interest.

Solution

Qualifying Asset as per AS-16 = ₹ 50 lakhs (construction of a shed)

Borrowing cost to be capitalized = $18 \times 50/120$ = ₹ 7.5 lakhs

Interest to be debited to Profit or Loss account = ₹ (18 – 7.5) lakhs
= ₹ 10.5 lakhs

Illustration 3

The company has obtained Institutional Term Loan of ₹ 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 2012 amounted to ₹ 406 lakhs, ₹ 58 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of ₹ 52.20 lakhs incurred during 2011-2012 on the entire Institutional Term Loan of ₹ 580 lakhs.

Solution

As per para 6 of AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred. Borrowing costs should be expensed except where they are directly attributable to acquisition, construction or production of qualifying asset.

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

The treatment for total interest amount of ₹ 52.20 lakhs can be given as:

Purpose	Nature	Interest to be charged to profit and loss account	Interest to be charged to profit and loss account
		₹ in lakhs	₹ in lakhs
Modernisation and renovation of plant and machinery	Qualifying asset	$^{**}52.20 \times \frac{406}{580} = 36.54$	
Advance to supplies for additional assets	Qualifying asset	$^{**}52.20 \times \frac{58}{580} = 5.22$	
Working Capital	Not a qualifying asset		$52.20 \times \frac{116}{580} = 10.44$
		<u>41.76</u>	<u>10.44</u>

* A substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case.

** It is assumed in the above solution that the modernization and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assts. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assts on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, ₹ 52.20 lakhs will be recognized as expense in the profit and loss account for year ended 31st March, 2012.

Illustration 4

The notes to accounts of X Ltd. for the year 2011-2012 include the following:

"Interest on bridge loan from banks and Financial Institutions and on Debentures specifically obtained for the Company's Fertiliser Project amounting to ₹ 1,80,80,000 has been capitalized during the year, which includes approximately ₹ 1,70,33,465 capitalised in respect of the utilization of loan and debenture money for the said purpose." Is the treatment correct? Briefly comment.

Solution

The treatment done by the company is not in accordance with AS 16 'Borrowing Costs'. As per para 10 of AS 16, to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period. Hence, the capitalisation of borrowing costs should be restricted to the actual amount of interest expenditure i.e. ₹ 1,70,33,465. Thus, there is an excess capitalisation of ₹ 10,46,535. This has resulted in overstatement of profits by ₹ 10,46,535 and amount of fixed assets

has also gone up by this amount.

Illustration 5

XYZ Ltd., has undertaken a project for expansion of capacity as per the following details:

	Plan ₹	Actual ₹
April, 2012	2,00,000	2,00,000
May, 2012	2,00,000	3,00,000
June, 2012	10,00,000	–
July, 2012	1,00,000	–
August, 2012	2,00,000	1,00,000
September, 2012	5,00,000	7,00,000

The company pays to its bankers at the rate of 12% p.a., interest being debited on a monthly basis. During the half year company had ₹ 10 lakhs overdraft upto 31st July, surplus cash in August and again overdraft of over ₹ 10 lakhs from 1.9.2012. The company had a strike during June and hence could not continue the work during June. Work was again commenced on 1st July and all the works were completed on 30th September. Assume that expenditure were incurred on 1st day of each month. Calculate:

- (i) Interest to be capitalised.
- (ii) Give reasons wherever necessary.

Assume:

- (a) Overdraft will be less, if there is no capital expenditure.
- (b) The Board of Directors based on facts and circumstances of the case has decided that any capital expenditure taking more than 3 months as substantial period of time.

Solution

(a) XYZ Ltd.

Month	Actual Expenditure	Interest Capitalised	Cumulative Amount	
	₹	₹	₹	
April, 2012	2,00,000	2,000	2,02,000	
May, 2012	3,00,000	5,020	5,07,020	
June, 2012	–	5,070	5,12,090	Note 2
July, 2012	–	5,120	5,17,210	
August, 2012	1,00,000	–	6,17,210	Note 3
September, 2012	<u>7,00,000</u>	<u>10,000</u>	<u>13,27,210</u>	Note 4
	<u>13,00,000</u>	<u>27,210</u>	<u>13,27,210</u>	

Note:

1. There would not have been overdraft, if there is no capital expenditure. Hence, it is a case of specific borrowing as per AS 16 on Borrowing Costs.
2. The company had a strike in June and hence could not continue the work during June. As per para 14 (c) of AS 16, the activities that are necessary to prepare the asset for its intended use or sale are in progress. The strike is not during extended period. Thus during strike period, interest need to be capitalised.
3. During August, the company did not incur any interest as there was surplus cash in August. Therefore, no amount should be capitalised during August as per para 14(b) of AS 16.
4. During September, it has been taken that actual overdraft is ₹ 10 lakhs only. Hence, only ₹ 10,000 interest has been capitalised even though actual expenditure exceeds ₹ 10 lakhs.

Alternatively, interest may be charged on total amount of (₹ 6,17,210 + ₹ 7,00,000 = 13,17,210) for the month of September, 2012 as it is given in the question that overdraft was over ₹ 10 lakhs from 1.9.2012 and not exactly ₹ 10 lakhs. In that case, interest amount ₹ 13,172 will be capitalised for the month of September.

As 17**Illustration 1**

Prepare a segmental report for publication in Diversifiers Ltd. from the following details of the company's three divisions and the head office:

	₹ ('000)
<i>Forging Shop Division</i>	
Sales to Bright Bar Division	4,575
<i>Other Domestic Sales</i>	90
<i>Export Sales</i>	<u>6,135</u>
	<u>10,800</u>

<i>Bright Bar Division</i>	
<i>Sales to Fitting Division</i>	45
<i>Export Sales to Rwanda</i>	<u>300</u>
	<u>345</u>
<i>Fitting Division</i>	
<i>Export Sales to Maldives</i>	<u>270</u>

<i>Particulars</i>	<i>Head Office</i> ₹ ('000)	<i>Forging Shop Division</i> ₹ ('000)	<i>Bright Bar Division</i> ₹ ('000)	<i>Fitting Division</i> ₹ ('000)
<i>Pre-tax operating result</i>		240	30	(12)
<i>Head office cost reallocated</i>		72	36	36
<i>Interest costs</i>		6	8	2
<i>Fixed assets</i>	75	300	60	180
<i>Net current assets</i>	72	180	60	135
<i>Long-term liabilities</i>	57	30	15	180

Solution

Diversifiers Ltd.
Segmental Report

(₹ '000)

<i>Particulars</i>	<i>Divisions</i>			<i>Inter Segment Eliminations</i>	<i>Consolidated Total</i>
	<i>Forging shop</i>	<i>Bright Bar</i>	<i>Fitting</i>		
<i>Segment revenue</i>					
<i>Sales:</i>					
Domestic	90	—	—	—	90
Export	<u>6,135</u>	<u>300</u>	<u>270</u>	—	<u>6,705</u>
External Sales	6,225	300	270	—	6,795
Inter-segment sales	<u>4,575</u>	<u>45</u>	—	<u>4,620</u>	—
Total revenue	<u>10,800</u>	<u>345</u>	<u>270</u>	<u>4,620</u>	<u>6,795</u>
Segment result (given)	240	30	(12)		258
Head office expenses					<u>(144)</u>
Operating profit					114
Interest expense					<u>(16)</u>
Profit before tax					<u>98</u>
<i>Information in relation to assets and liabilities:</i>					

Fixed assets	300	60	180	—	540
Net current assets	<u>180</u>	<u>60</u>	<u>135</u>	—	<u>375</u>
Segment assets	<u>480</u>	<u>120</u>	<u>315</u>	—	915
Unallocated corporate assets (75 + 72)	—	—	—	—	<u>147</u>
Total assets					<u>1,062</u>
Segment liabilities	30	15	180	—	225
Unallocated corporate liabilities					<u>57</u>
Total liabilities					<u>282</u>

Sales Revenue by Geographical Market

	Home Sales	Export Sales (by forgoing shop division)	Export to Rwanda	Export to Maldives	(₹ '000) Consolidated Total
External sales	90	6,135	300	270	6,795

Illustration 2

Microtech Ltd. produces batteries for scooters, cars, trucks, and specialised batteries for invertors and UPS. How many segments should it have and why?

Answer

In case of Microtech Ltd., the basic product is the batteries, but the risks and returns of the batteries for automobiles (scooters, cars and trucks) and batteries for invertors and UPS are affected by different set of factors. In case of automobile batteries, the risks and returns are affected by the Government policy, road conditions, quality of automobiles, etc. whereas in case of batteries for invertors and UPS, the risks and returns are affected by power condition, standard of living, etc. Therefore, it can be said that Microtech Ltd. has two business segments viz- 'Automobile batteries' and 'batteries for Invertors and UPS'.

As-18

Illustration 1

Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3-2012. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?

Solution

As per paragraph 13 of AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise that have a member of key management

in common with the reporting enterprise.

In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is wrong.

Illustration 2

Mr. Raj a relative of key Management personnel received remuneration of ₹ 2,50,000 for his services in the company for the period from 1.4.2011 to 30.6.2011. On 1.7.2011 he left the service.

Should the relative be identified as at the closing date i.e. on 31.3.2010 for the purposes of AS 18?

Solution

According to para 10 of AS 18 on Related Party Disclosures, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Raj, a relative of key management personnel should be identified as relative as at the closing date i.e. on 31.3.2012.

Illustration 3

X Ltd. sold goods to its associate Company for the 1st quarter ending 30.6.2012. After that, the related party relationship ceased to exist. However, goods were supplied as was supplied to any other ordinary customer. Decide whether transactions of the entire year has to be disclosed as related party transaction.

Solution

As per para 23 of AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2012 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist need not be reported.

As-19

A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

- (a) Sale price of ₹50 lakhs is equal to fair value.*
- (b) Fair value is ₹ 60 lakhs.*
- (c) Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.*
- (d) Fair value is ₹ 40 lakhs and sale price is ₹50 lakhs.*
- (e) Fair value is ₹46 lakhs and sale price is ₹ 50 lakhs*
- (f) Fair value is ₹35 lakhs and sale price is ₹39 lakhs.*

Solution

Following will be the treatment in the given cases:

- (a) When sales price of ₹ 50 lakhs is equal to fair value, A Ltd. should immediately recognize the profit of ₹10 lakhs (i.e. 50 – 40) in its books.
- (b) When fair value is ₹ 60 lakhs then also profit of ₹10 lakhs should be immediately recognized by A Ltd.
- (c) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognized by A Ltd. in its books provided loss is not compensated by future lease payment.
- (d) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortized over the lease period.
- (e) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 - 40) to be immediately recognized in its books and balance profit of ₹4 lakhs (50-46) is to be amortised/deferred over lease period.
- (f) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognized by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period

Illustration 4

A Ltd. leased a machinery to B Ltd. on the following terms:

	(₹ in Lakhs)
<i>Fair value of the machinery</i>	<i>20.00</i>
<i>Lease term</i>	<i>5 years</i>
<i>Lease Rental per annum</i>	<i>5.00</i>
<i>Guaranteed Residual value</i>	<i>1.00</i>
<i>Expected Residual value</i>	<i>2.00</i>
<i>Internal Rate of Return</i>	<i>15%</i>

Depreciation is provided on straight line method @ 10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

Solution**Computation of Unearned Finance Income**

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

where :

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

$$\begin{aligned}
 \text{Gross investment} &= \text{Minimum lease payments} + \text{Unguaranteed residual value} \\
 &= (\text{Total lease rent} + \text{Guaranteed residual value}) + \text{Unguaranteed residual value} \\
 &= [(\text{₹ } 5,00,000 \times 5 \text{ years}) + \text{₹ } 1,00,000] + \text{₹ } 1,00,000 \\
 &= \text{₹ } 27,00,000
 \end{aligned}$$

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

Year	MLP inclusive of URV	Internal rate of return (Discount factor 15%)	Present Value	
	₹		₹	
1	5,00,000	.8696	4,34,800	
2	5,00,000	.7561	3,78,050	
3	5,00,000	.6575	3,28,750	
4	5,00,000	.5718	2,85,900	
5	5,00,000	.4972	2,48,600	
	1,00,000	.4972	49,720	
	(guaranteed residual value)			
			17,25,820	(i)
	1,00,000	.4972	49,720	(ii)
	(unguaranteed residual value)			
		(i) + (ii)	17,75,540	(b)

$$\text{Unearned Finance Income} = (a) - (b)$$

$$= \text{₹ } 27,00,000 - \text{₹ } 17,75,540 = \text{₹ } 9,24,460$$

Journal Entries in the books of B Ltd.

	₹	₹
<i>At the inception of lease</i>		
Machinery account	Dr. 17,25,820*	
To A Ltd.'s account		17,25,820*
(Being lease of machinery recorded at present value of MLP)		
<i>At the end of the first year of lease</i>		
Finance charges account (Refer Working Note)	Dr. 2,58,873	
To A Ltd.'s account		2,58,873
(Being the finance charges for first year due)		
A Ltd.'s account	Dr. 5,00,000	
To Bank account		5,00,000
(Being the lease rent paid to the lessor which includes outstanding liability of ₹ 2,41,127 and finance charge of ₹ 2,58,873)		
Depreciation account	Dr. 1,72,582	
To Machinery account		1,72,582
(Being the depreciation provided @ 10% p.a. on straight line method)		
Profit and loss account	Dr. 4,31,455	
To Depreciation account		1,72,582
To Finance charges account		2,58,873
(Being the depreciation and finance charges transferred to profit and loss account)		

As-20**Illustration 1**

<i>Date</i>	<i>Particulars</i>	<i>Purchased</i>	<i>Sold</i>	<i>Balance</i>
1st January	Balance at beginning of year	1,800	-	1,800
31st May	Issue of shares for cash	600	-	2,400
1st November	Buy Back of shares	-	300	2,100

Calculate Weighted Number of Shares.

Solution

Computation of Weighted Average:

$$(1,800 \times 5/12) + (2,400 \times 5/12) + (2,100 \times 2/12) = 2,100 \text{ shares.}$$

The weighted average number of shares can alternatively be computed as follows:

$$(1,800 \times 12/12) + (600 \times 7/12) - (300 \times 2/12) = 2,100 \text{ shares}$$

Illustration 2

<i>Date</i>	<i>Particulars</i>	<i>No. of Share Face Value</i>	<i>Paid up Value</i>	
1st January	Balance at beginning of year	1,800	₹ 10	₹ 10
31st October	Issue of Shares	600	₹ 10	₹ 5

Calculate Weighted Number of Shares.

Solution

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

$$(1,800 \times 12/12) + (300 \times 2/12) = 1,850 \text{ shares.}$$

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Illustration 3

<i>Net profit for the year 2011</i>	<i>₹ 18,00,000</i>
<i>Net profit for the year 2012</i>	<i>₹ 60,00,000</i>
<i>No. of equity shares outstanding until 30th September 2012</i>	<i>20,00,000</i>
<i>Bonus issue 1st October 2012 was 2 equity shares for each equity share outstanding at 30th September, 2012</i>	
<i>Calculate Basic Earnings Per Share.</i>	

Solution

No. of Bonus Issue $20,00,000 \times 2 = 40,00,000$ shares

Earnings per share for the year 2012 $\frac{\text{₹ } 60,00,000}{(20,00,000 + 40,00,000)} = \text{₹ } 1.00$

Adjusted earnings per share for the year 2011 $\frac{\text{₹ } 18,00,000}{(20,00,000 + 40,00,000)} = \text{₹ } 0.30$

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

In a **rights issue**, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex - rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

and dividing by the number of shares outstanding after the exercise of the rights.

Illustration 4

Net profit for the year 2011 ₹ 11,00,000

Net profit for the year 2012 ₹ 15,00,000

No. of shares outstanding prior to rights issue 5,00,000 shares

Rights issue price ₹ 15.00

Last date to exercise rights 1st March 2012

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)

Fair value of one equity share immediately prior to exercise of rights on 1st March 2012 was ₹ 21.00. Compute Basic Earnings Per Share.

Solution

$$\frac{\text{Fair value of shares immediately prior to exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{Number of shares issued in the exercise}}$$

$$\frac{(\text{₹ } 21.00 \times 5,00,000 \text{ shares}) + (\text{₹ } 15.00 \times 1,00,000 \text{ Shares})}{5,00,000 \text{ Shares} + 1,00,000 \text{ Shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}}$$

$$\frac{\text{₹ } (21.00)}{\text{₹ } (20.00)} = 1.05$$

Computation of earnings per share:

EPS for the year 2011 as originally reported: ₹ 11,00,000/5,00,000 shares = ₹ 2.20

EPS for the year 2011 restated for rights issue: ₹ 11,00,000/ (5,00,000 shares x 1.05) = ₹ 2.10

EPS for the year 2012 including effects of rights issue:

$$(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12) = 5,87,500 \text{ shares}$$

$$\text{EPS} = 15,00,000/5,87,500 = ₹ 2.55$$

Illustration 5

<i>Net profit for the current year</i>	<i>₹ 1,00,00,000</i>
<i>No. of equity shares outstanding</i>	<i>50,00,000</i>
<i>Basic earnings per share</i>	<i>₹ 2.00</i>
<i>No. of 12% convertible debentures of ₹ 100 each</i>	<i>1,00,000</i>
<i>Each debenture is convertible into 10 equity shares</i>	
<i>Interest expense for the current year</i>	<i>₹ 12,00,000</i>
<i>Tax relating to interest expense (30%)</i>	<i>₹ 3,60,000</i>

Compute Diluted Earnings Per Share.

Solution

Adjusted net profit for the current year $(1,00,00,000 + 12,00,000 - 3,60,000) = ₹ 1,08,40,000$

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS: $(50,00,000 + 10,00,000) = 60,00,000$ Shares

Diluted earnings per share: $(1,08,40,000/60,00,000) = ₹ 1.81$

Illustration 6

<i>Net profit for the year 2011</i>	<i>₹ 12,00,000</i>
<i>Weighted average number of equity shares outstanding during the year 2011</i>	<i>5,00,000 shares</i>
<i>Average fair value of one equity share during the year 2011</i>	<i>₹ 20.00</i>
<i>Weighted average number of shares under option during the year 2011</i>	<i>1,00,000 shares</i>
<i>Exercise price for shares under option during the year 2011</i>	<i>₹ 15.00</i>

Compute Basic and Diluted Earnings Per Share.

Solution**Computation of earnings per share**

	<i>Earnings</i> ₹	<i>Shares</i>	<i>Earnings/ Share</i> ₹
Net profit for the year 2011	12,00,000		
Weighted average no. of shares during year 2011		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value $(100,000 \times 15.00)/20.00$		(75,000)	
Diluted earnings per share	<u>12,00,000</u>	<u>5,25,000</u>	<u>2.29</u>

X Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

<i>(Accounting year 1.1.2010 – 31.12.2010)</i>		
<i>Net Profit</i>	:	<i>Year 2010: ₹ 20,00,000</i>
	:	<i>Year 2011 : ₹ 30,00,000</i>
<i>No. of shares outstanding prior to Right Issue</i>	:	<i>10,00,000 shares</i>
<i>Right Issue</i>	:	<i>One new share for each four outstanding i.e., 2,50,000 shares.</i>
		<i>Right Issue price – ₹ 20</i>
		<i>Last date of exercise rights – 31.3.2011.</i>
<i>Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2011</i>	:	<i>₹ 25</i>

Solution

Computation of Basic Earnings Per Share (as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	<i>Year 2010 ₹</i>	<i>Year 2011 ₹</i>
EPS for the year 2010 as originally reported		
= $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$		
= (₹ 20,00,000 / 10,00,000 shares)	2.00	
EPS for the year 2010 restated for rights issue		
= [₹ 20,00,000 / (10,00,000 shares × 1.04*)]	1.92 (approx.)	
EPS for the year 2011 including effects of rights issue		
$\frac{\text{₹ 30,00,000}}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$		
$\frac{\text{₹ 30,00,000}}{11,97,500 \text{ shares}}$		2.51 (approx.)

Working Notes:

1. Computation of theoretical ex-rights fair value per share

Fair value of all outstanding shares immediately prior to
exercise of rights + Total amount received from exercise

Number of shares outstanding prior to exercise +
Number of shares issued in the exercise

$$= \frac{(\text{₹ } 25 \times 10,00,000 \text{ shares}) + (\text{₹ } 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}}$$

$$= \frac{\text{₹ } 3,00,00,000}{12,50,000 \text{ shares}} = \text{₹ } 24$$

Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}}$$

$$= \frac{\text{₹ } 25}{\text{₹ } 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

Illustration 1

Net profit for the year 2010	₹ 18,00,000
Net profit for the year 2011	₹ 60,00,000
No. of equity shares outstanding until 30th September 2011	20,00,000

Bonus issue 1st October 2011 was 2 equity shares for each equity share outstanding at 30th September, 2011.

Calculate Basic Earnings Per Share.

Solution

No. of Bonus Issue = 20,00,000 x 2 = 40,00,000 shares

$$\text{Earnings per share for the year 2011} = \frac{\text{₹ } 60,00,000}{(20,00,000 + 40,00,000)} = \text{₹ } 1.00$$

$$\text{Adjusted earnings per share for the year 2010} = \frac{\text{₹ } 18,00,000}{(20,00,000 + 40,00,000)} = \text{₹ } 0.30$$

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year was 2010, the earliest period reported.

... ..