AS-1

DISCLOSURE OF ACCOUNTING POLICIES

The preparation of financial statements is the responsibility of the management of an enterprise. This includes selecting appropriate accounting policies and applying them consistently from one period to another. Financial statements include - (a) Profit & Loss Account, Balance Sheet, Cash Flow (if prepared) and Notes to accounts.

PURPOSE

- To Promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner.
- To facilitate meaningful comparison between financial statements of different enterprises.

MEANING OF ACCOUNTING POLICIES

1. *Specific accounting principles* and

2. #Methods# of applying those principles in preparation and presentation of financial statements

e.g. * Inventory should be valued at cost or net realizable value whichever is lower # cost formula such as FIFO applied in calculating the cost of inventories. e.g. * Tangible Fixed Assets should be valued at historical costs and should be depreciated over its useful life. # Method of calculating Depreciation by using SLM or WDV

[Describe briefly the term "Accounting policies" (CA-FINAL, MAY 1992 (2 MARKS)]

AREAS IN WHICH DIFFERING ACCOUNTING POLICIES ARE ENCOUNTERED

- Treatment of Goodwill (e.g. Capitalisation Method, Super Profit Method)
- Valuation of Inventories (e.g. FIFO, Weighted Average Method)
- Valuation of Investments (e.g. lower of cost and fair value)
- Valuation of Fixed Assets (e.g. Historical cost, revalued amount)
- Methods of Depreciation (e.g. WDV Method, SLM Method)

- Treatment of profit on long-term contracts (e.g. proportionate completion method)
- Methods of translation of foreign currency (e.g. avg. rate, TT, buying rate)

[Mention any six areas in which different accounting policies may be adopted by different enterprises. (CA-FINAL, MAY 1995 (6 MARKS)]

CONSIDERATIONS IN THE SELECTION OF ACCOUNTING POLICIES

PRIMARY CONSIDERATION

The financial statements prepared & presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise.

SECONDARY CONSIDERATION

- Prudence *(i.e. policy of conservatism)*

This concept is expressed as : "Recognise all losses and anticipated no gains". This concept attempts to state the lowest likely value of assets and profits, and highest likely amount of any losses or liabilities incurred.

e.g. The most common example of exercise of prudence in selection of accounting policy is the policy of valuing inventory at lower of cost and net realisable value.

However, Exercise of prudence does not allow
-the creation of hidden reserve or excessive provisions,
-the deliberate understates of assets and income,
-the deliberate overstatement of liabilities and losses.
If the above are done, financial statements would not be natural and therefore not be reliable.

E.G. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.

E.G. A Ltd. Has secured a patent whose legal life is 20 years, the patented product is likely to sell for 10 years. But the company intends to amortize the patent over 3 years – on grounds of prudence.
Ans. Prudence does not justify deliberate overstatement of expenses. Hence, an unreasonably short useful life is not justified.

⌗ Substance over form *(i.e. recording transactions considering economic reality and not merely the legality.)*

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

e.g. Accounting for hire-purchase transactions, the hire purchaser can record the asset at its cash down price, while paying for it by installments over an agreed period of time.

e.g. A Ltd. Has sold its building for Rs. 50 lakhs and purchaser has paid the full price. Company has given possession to the purchaser. The book value of building is Rs. 35 Lakhs. As at 31st March 2003, documentation and legal formalities are pending. The company has not recorded the disposal. It has shown amount received as advance. Do you agree with this treatment?
Ans. Although legal title has not been transferred, the economic reality and substance is that the right and beneficial interest in the immovable property have been transferred.
Seller's Point of View :- A Ltd. Should record the the sale and recognize the profit of Rs. 15 lakhs in its Profit and loss accounts. It should eliminate the building from its balance sheet. In notes to accounts it should disclose that building has been sold, full consideration has been received and possession has been handed over to the buyer and documentation and legal formalities are pending.
Buyer's Point of View :- The buyer should recognize the building as an asset in his balance sheet and charge depreciation on it. The buyer should disclose in the notes to accounts that possession has been received and documentation and legal formalities are pending.

⌗ Materiality *(i.e. an item that influences decisions of users of financial statements.*

Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement.

Materiality is not always a matter of relative size. Both amount (quantity and nature (quality) of mis-statement should be considered while judging material materiality.

E.G. A small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to the user of Financial Statement to avoid greater losses in future.

E.G. Payment of panalties/fines for violation of law should be disclosed separately, even if the amount is negligible. It should not be clubbed together with "Office Expenses".

[What are the major considerations, which govern the selection and application of accounting policies (CA-Inter Nov. 1995(6 Marks)

HINT : Give detail about on primary consideration and secondary consideration]

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

- **GOING CONCERN** *(i.e. continuing in operation for the foreseeable)*

The financial statements are normally prepared on the assumption that an enterprise will continue in operation in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Going concern assumption is not likely to be compatible with the intention or necessity to enter into a scheme of arrangement with the enterprise's creditors or to liquidate in near future.
Foreseeable Future generally a period not to exceed one year after balance sheet date.

- **CONSISTENCY** *(i.e. following consistent accounting policy from one period to another)*

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required (i) by a statute (ii) by an accounting standard (iii) for more appropriate presentation of financial statements.

However, consistency is not an excuse to adopt or continue to adopt inappropriate accounting policies.

- **ACCRUAL** *(i.e. mercantile system of accounting)*

The users of financial statements assume that the financial statements have been prepared on accrual basis. Under accrual basis of accounting revenues and costs are recognized as they are earned or incurred, not as money is received or paid.

Section 128(1) of the Companies Act, 2013 makes it mandatory for companies to maintain accounts on accrual basis only.

These are not specifically stated in the financial statements. Their acceptance and usage is assumed.

[Write a short note on fundamental accounting assumptions (CA- Inter may 2001, Nov. 1994 (4 Marks)]

DISCLOSURE OF ACCOUNTING POLICIES

- **All significant accounting policies** adopted should be disclosed.
- The disclosure should **form part of the financial statements.**
- Any change in the accounting policies which has a **material effect in the current period** should be disclosed along with amount of effect.
- If **the fundamental accounting assumptions is not followed**, the fact should be disclosed.

[Briefly describe, the requirements of AS-1 in regard to disclosure of significant policies. CA-Final May 1995 (8 Marks)]

AS-2

VALUATION OF INVENTORIES

The valuation of inventory has direct impact on cost and profit measurement. Higher the value of closing inventory results in larger profit. Hence the proper valuation of Inventory is necessary since decision of user of financial statement may be affected after notice such higher profit.

PURPOSE

- Specifies the principals for valuing the inventory.
- Disclosure of the specific policies adopted by the management for the valuation of inventory.

Inventories are assets :

- held for sale in the ordinary course of business. (e.g. finished car ready to be dispatched to the dealers)
- in the process of production for such sale.(e.g. car in the assembly lines)
- in the form of materials or supplies to be consumed in the production process or in the rendering of services. (e.g. tyre, battery, headlights etc.)

[As per Accounting Standard – 2 (Revised) 'Valuation of Inventories', what is meant by the term 'inventories'? (RTP Nov. 2011)]

Inventories do not include machinery spares, standby Equipment, servicing equipment if these item covered in definition of PPE of AS-10.

This standard should be applied in accounting for inventories **other than**:

- Work-in-progress in construction contract and directly related service contract (ref: AS-7) However inventories not forming part of construction work-in-progress will attract AS-2; Inventory held for use in construction, e.g. cement lying at the site shall be covered by AS-2

- Work-in-progress arising in the ordinary course of business of service providers. i.e. cost of providing a part of service.

e.g. For a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress.
Work-in-progress may arise for different other services E.g. software development, consultancy, medical services, merchant banking and so on.

- Shares, debentures and other financial instruments held as stock-in-trade (ref: AS-13 as Current Investments)
- **Producer's** inventories like livestock, agricultural and forest product, mineral oil/gasses as measured at net realizable value as per trade practices at certain stage of production.

> E.G. Grow more Pvt. Ltd. A wholesaler in food and other agro products has valued the year end Inventory on Net Realisable Value on the ground that AS-2 does not apply to inventory of Agricultural Products. Comment
>
> ANS. **Producer's** inventories like livestock, agricultural and forest product, mineral oil/gasses as measured at net realizable value as per trade practices at certain stage of production. The above principle does not apply to Trader's Inventory of Food and Agro Products. In the above case Grow more Pvt. Ltd. is only a trader (wholesaler) not the producer. Hence they cant value their inventory at NRV. The company should value the inventory at lower of cost or Net realizable value.

MEASUREMENT OF INVENTORY

Inventories should be valued at the *lower of Cost and Net Realisable Value*.

[State the general principle of valuation of inventories laid down by accounting standard-2 (RTP Nov. 2011)]

COST OF INVENTORY

The *cost of inventories* should comprise:

(i) **Cost of purchase (ii) Cost of conversion (iii) Other costs**

- **Cost of purchase**

Purchase Price including Duties and Taxes (excluding tax refunds/credit)	Xxx
Add:- Freight Inwards	xxx
Add:- Other Expenditure directly attributable to the purchase viz. brokerage on purchase, packing cost of transportation etc.	xxx
Less:- Trade Discount, Rebate, Duty drawback & other similar items	(xxx)
Cost of Purchase	**xxx**

E.G. Nidhi Ltd. purchased raw materials at a basic price of Rs.10,000 on which excise duty of Rs.1500 is paid. Cost of inventory (of raw materials) at this stage would be Rs.11,500. The material is thereafter processed. For this purpose conversion costs (labour and direct overheads, and other fixed production overheads) amounting to Rs.1,800 are incurred. Excise duty liability on finished goods amounting Rs.1,700 is being paid by the company. Company is entitled for a CENVAT credit of Rs.1,500. Compute the value of inventory. *(RTP Nov. 2010)*

Answer Since Nidhi Ltd. is entitled to a CENVAT credit of Rs.1,500, excise duty payable on finished goods is notionally adjusted against excise duty paid on materials consumed. Thus, CENVAT related excise duty cannot be included as a part of the cost of inventory. The cost of inventory would thus be valued at Rs.13,500 (11,500 + 1,800 + 1,700 – 1,500) only.]

E.G. Pepsi India Ltd. purchased 20,000 kgs. of oranges from farmer of Hosierpur, Punjab @ Rs. 10 per kg. Orange collecting agent's commission were paid @ Re 1 per Kg and Rs. 8,000 were paid for lorry hire charges for transporting it to Noida Plant. 5% of the oranges were damaged in transit and discarded. This loss is a normal loss. Calculate the cost of purchase per kg. of orange.

Answer-

Purchase price (20000xRs. 10)	2,00,000
Agent's Commision (20,000xRe.1)	20,000
Transportation Cost	8,000
Total cost of (20,000-1,000)=19,000 kgs.	$\boxed{2,28,000}$

Purchase cost per kg. = Rs.2,28,000/19,000=Rs. 12

- **Cost of conversion**: includes:

- Labour Costs directly related to the production of finished goods

e.g. Wills Ltd. is having a readymade garment factory in Ludhiana, Punjab, where two products are manufactured-Sports T- Shirt and Track Suit. Direct Labours hours of 24,000 are used in each period. Cutting is done by computer controlled automatic machine. However, stitching is done manually. Workers are paid Rs. 50 for stitching one T- Shirt and Rs. 100 for stitching one track suits. Give your view. **Answer:** At the time of calculating cost of T-Shirt Rs. 50 is to be added and for calculating cost of Track suits Rs. 100 be added.

- Variable and Fixed production overheads that are incurred in converting materials into finished goods.

Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration.

E.g.
You are required to value the inventory per kg of finished goods consisting of:

	Rs. per kg.
Material cost	200
Direct labour	40
Direct variable overhead	20

Fixed production charges for the year on normal working capacity of 2 lakh kgs is Rs. 20 lakhs. 4,000 kgs of finished goods are in stock at the year end.(CA Adapted)
Answer As per AS 2, the cost of conversion include a systematic allocation of fixed and variable overheads that are incurred in converting materials into finished goods. The allocation of fixed overheads for the purpose of their inclusion in the cost of conversion is based on normal capacity of the production facilities.
Cost per kg of finished goods:

		₹
Material Cost		200
Direct Labour	40	
Direct Variable Production Overhead	20	
Fixed Production Overhead $\left(\frac{20,00,000}{2,00,000}\right)$	10	70
		270

Hence the value of 4,000 kgs. of finished goods = 4,000 kgs x ₹ 270
= ₹ 10,80,000

- **Where actual production is less than or equal to normal capacity, fixed overheads are recovered on the basis of normal capacity. (AP<NP, Use NP)**
- **Where actual production is more than normal capacity, fixed overheads are recovered on the basis of actual production. . (AP>NP, Use AP)**

e.g. Normal output of your factory is 20,000 units per month. You normally charge fixed overhead per unit @ Rs. 20. To complete a special order from china, your factory works overtime every weekend for last 4 months. New level output is 25,000 units per month.
Total fixed overhead per month = Rs. 20 x 20,000 = Rs. 4,00,000.
Under changed circumstances, the fixed overhead rate will be reduced:
New Rate: Rs 4,00,000/25000 =Rs. 16

E.g. Lambodar Ltd's normal production volume is 50,000 units and the Fixed Overheads are estimated at Rs. 5,00,000. Give the treatment of Fixed production OH under AS-2, if actual Production during a period was :- (a) 42,000 units (b) 50,000 units and (c) 60,000 units.

Solution

Fixed Overhead	**Normal capacity**	**Actual Capacity**	**F. Oh. Rate as per Normal Capacity**	**F. Oh. Rate as per Actual Capacity**	**Rate to be used for valuation**	**Inventories cost**	**Period cost**
500000	50000	42000	10	11.90	10	420000	8000
500000	50000	50000	10	10	10	500000	Nil
500000	50000	60000	10	8.33	8.33	500000	Nil

Point to be noted **Normal Capacity** represents production expected to be achieved on an average over a number of periods or seasons under normal circumstances (Normal Capacity = Total capacity less Plant Maintenance Time)

However low production levels, or idle plant for abnonrmal reasons are not taken into consideration in determining the Normal capacity.

E.g. Before Diwali you close the factory for routine maintenance and cleaning. You follow 5 days a week and single shift each day. At the time of calculating normal capacity all these factors must be taken into consideration. It should not be calculated on the basis of calendar days. E.g. Productions were suspended for 4 weeks for flood. The above period should not be less for calculation of Normal Capacity.

- **<u>Other costs</u>**: included only to the extent they are incurred in bringing the inventories to their present location and condition.
  - ✓ These would include inward transport and storage costs prior to completion of production or the cost of designing products for specific customers.
  - ✓ It should be noted that interest other borrowing costs are not included in the cost of inventories.

E.g. How would you deal with the following in the annual accounts of a company for the year ended 31.3.2013? "The company has to pay delayed cotton clearing charges over and above the negotiated price for asking delayed delivery of cotton from the supplier's godown. Up to 2011-12, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2012-13. This would result into decrease in profit by Rs. 7.60 lakhs." **Solution:** As per para 12, AS 2, Valuation of Inventories, interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories. Thus, it becomes quite clear that delayed cotton clearing charges which were treated in the nature of interest must not be included while valuing closing stock as per the provision of AS 2 and it is not in compliance with AS 2 which was done up to 2010-11.But from year 2011-12, the company decided to change the earlier view i.e. they decided to exclude the same from the valuation of closing stock which is, no doubt, in compliance with AS 2. As a result of change in accounting policy regarding valuation of stock the profit was reduced by is Rs. 7.60 lakhs which must be disclosed in the financial statement or per AS 1 as Notes to

Account.

EXCLUSIONS FROM THE COST

- Abnormal wastages of materials, labour or other production costs.
- Storage costs, unless they are necessary in the production process.
- Administrative overheads which do not contribute to bringing the inventories to their present location and condition.
- Selling and distribution overheads.

According to AS-2, which of the following costs should be included in valuing the inventories of a manufacturing company

Production Overhead	yes
Carriage outward	No
Depreciation of Factory Plant	yes
Factory Supervisor salary	yes
General Administrative Overhead	No
Finished Goods storage Cost	No

E.g. Anil Pharma Ltd. ordered 16,000 kg of certain material at `160 per unit. The purchase price includes excise duty Rs.10 per kg in respect of which full CENVAT credit is admissible. Freight incurred amounted to Rs.1, 40,160. Normal transit loss is 2%. The company actually received 15,500 kg and consumed 13,600 kg of material. Compute cost of inventory under AS 2 and amount of abnormal loss. (RTP May 2012)

Answer

Calculation of total cost of material as per AS-2

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

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

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

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

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

Abnormal loss in kg = Material after normal loss - Material actually received
=15,680 kg – 15,500 kg = 180 kg

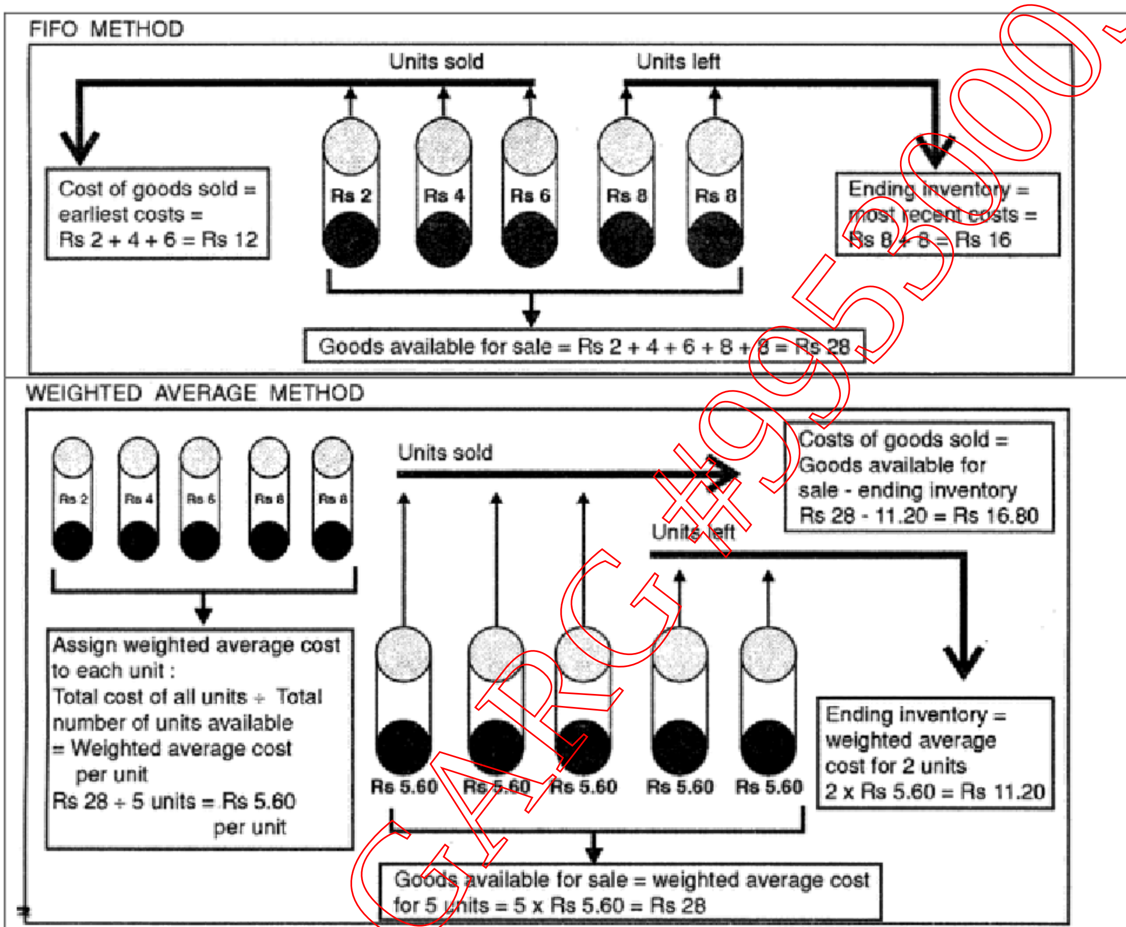
Abnormal loss in value = 180 kg x ₹ 162 = ₹ 29,160

Cost formulas

- **Following Cost formulas can be used:**
  - **Specific Identification Method**
  - **FIFO.**
  - **Weighted average.**
  - **LIFO**

Generally **Specific Identification Method** to be used when goods are not ordinarily interchangeable or have been segregated for specific projects. (e.g. X Ltd. deals in paintings of renowned artists, as paintings are not interchangeable.)

Weighted average cost or FIFO method is used in cases where goods are ordinarily interchangeable.



Technique for the Measurement of Cost- Standard Cost Method and the Retail Method

Many industries would have their unique way of identifying costs, as the items dealt are huge and having frequent fluctuations. Either standard cost shall be used taking normal capacity in computation or retail method of arriving at cost shall be used.

Standard cost formula method is often used in manufacturing industry and retail formula method is used in trading activity units.

(a) Standard Cost Method:-

- ✓ Under this method, the cost of Inventories is measured on the basis of pre-determined standards.
- ✓ Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation.
- ✓ The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions.
- ✓ Standard Cost may be used for convenience if the results approximately the actual cost.

e.g. In order to value the inventory of finished goods, Sona Ltd. has adopted the standard cost of raw material, labour and overheads. Income tax officer wants to know the method, as per AS-2, for the valuation of raw material.

Answer The use of standard cost of elements of cost of production has been suggested by AS-2 as a matter of convenience only. In fact, AS-2 aims to suggest the use of absorption costing based on normal capacity. AS-2 says that standard cost system may be used for convenience if the results approximate the actual cost. If the company can adopt absorption costing for value of inventory, then the standard cost systems need not be adopted.

(b) Retail Method :-

- ✓ This method is applicable in following stuations
  - Retail trade
  - Inventories of large numbers of rapidly changing items

  -Similar Profit Margins

  -Impracticable to use other costing methods

- ✓ Retail Method may be used for Convenience, if the result approximate the actual cost.
- ✓ **Measurement :**
  Cost of Inventory = Sales value of Inventory *less* Appropriate Gross margin percentage.

E.g.

A trader purchased certain articles for ₹ 85,000. He sold some these articles for ₹ 1,05,000. The average percentage of gross margin is 25% on cost. Opening stock of inventory at cost was ₹ 15,000. Cost closing inventory is shown below.

	₹
Sale value of opening stock and purchase (₹ 85,000 + ₹ 15,000) x 1.25	*1,25,000*
Sales	*1,05,000*
Sale value of unsold stock	*20,000*
Less: Gross Margin (₹ 20,000 / 1.25) x 0.25	*4,000*
Cost of inventory	*16,000*

Net Realisable Value for Finished Goods and WIP

Particulars	F. G. Amt.	WIP Amt.
Estimated Selling Price in Ordinary course of Business	Xxx	Xxx
Less :- Estimated Cost of Completion	N.A.	(xxx)
Less :- Estimated Cost necessary to make the sale	(xxx)	(xxx)
Net Realisable Value	**xxx**	**xxx**

Logic: - The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.

e.g. Cost of a partly finished unit at the end of 2009-10 is Rs.800. The unit can be finished next year by a further expenditure of Rs.100. The finished unit can be sold Rs. 250, subject to payment of 4% brokerage on selling price. Give your view.

Answer: The value of inventory is determined below:

Net selling price	Rs. 250
Less: Estimated cost of completion	Rs.100
Less: Brokerage (4% of 250)	Rs. 10
Net Realisable Value	*Rs.140*
Cost of inventory	Rs.800

Value of inventory (Lower of cost and net realisable value) Rs.140

Note: Incremental cost Rs.100 (cost to complete) is less than incremental revenue Rs. 240 (Rs.250 – Rs.10). The enterprise will therefore decide to finish the unit for sale at Rs.250.

e.g. In example 1, suppose cost to complete the unit is Rs. 245 instead of Rs. 100. The enterprise will be better off by not finishing the unit as shown below:
Incremental cost Rs.245 (cost to complete) is more than incremental revenue Rs.240 (Rs.250 – Rs. 10). The enterprise will therefore prefer not to finish the unit.
Net Realisable Value = Nil
Cost = Rs. 800
Value of inventory (Lower of cost and net realisable value) = Nil

E.g. X Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 2010. Till March, 2011, 75% of the stocks were sold. The company wants to disclose closing stock at Rs.10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.2011. (May 2006)
ANS. As per AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost and net realizable value.
In this case, the cost of inventory is Rs.10 lakhs. The net realizable value is 11,00,000 × 90% =Rs.9,90,000. So, the stock should be valued at Rs.9,90,000

NRV in case of Firm Contract

- ✓ When Inventory Stock = Contact Quantity : Contact price
- ✓ When Inventory Stock > Contact Quantity
  - Contact Quantity is valued based on Contract Price
  - Excess Quantity is valued based on General Selling Price

E.g. X Ltd. purchased 10,000 barrels of crude oil @ Rs 4,400 per barrel. At the end of the period. it has a contract to sell 10.000 barrels @ Rs 4,000 per barrel. However. the market price is Rs 3,600 per barrel at the year end.
Here. for the purpose of calculating net realisable value, the contract price Rs 4.000 per barrel is to be taken into consideration.
The value of stock will be : 10,000 X Rs 4,000 = Rs 4,00,00,000.
Taking the above example. let us assume that X Ltd. has a contract to sell 9.000 barrels @ Rs 4,000 per barrel.

Here net realisable value is to be calculated as follows:

9,000 @ Rs 4,000 per barrel	Rs 36000000
1,000 @ Rs 3,600 per barrel	Rs 3600000
Total	**Rs 39600000**

E.g. X Limited has purchased 1,00,000 units of a product @ Rs 800 per unit on 1.1.2008. On the Balance Sheet date. i.e ., 31.3.2008 there were 20.000 units in stock. Of these, 5,000 units are earmarked against sale contract at a price of Rs 900 each. The market price of the product has dropped to Rs 750. How the closing stock will be valued on 31.3.2008 ?

Solution

The inventory will be valued as under:

	Rs.
Inventory held against Contract 5,000 X (lower of Rs 800 and Rs 900)	40,00,000
Inventory held for resale 15,000 X (lower of Rs 800 and Rs 750)	1,12,50,000
Total value of inventory	**1,52,50,000**

Net Realisable Value for Raw Material

- **Normally, cost is the basis of valuation for Raw material. There is no NRV concept in the valuation of raw material. In case the replacement cost of the raw material had fallen, with finished goods (in which such raw material is incorporated) are likely to be sold at a price below cost, then the raw material should be valued at replacement (as NRV) cost.**

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost.

However, when there has been a decline in the price of materials and it is estimated that the cost of thefinished 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.

E.g. Raw materials inventory of a company includes 1 Kg. of certain material purchased at Rs. 100 per Kg. The price of the material is on decline and replacement cost of the inventory at the year-end is Rs. 80 per Kg. It is possible to incorporate the material in a finished product. The conversion cost (wages and overheads) is Rs. 120.

Inventory values for expected selling prices of the finished product (a) Rs. 195 (b)Rs. 230 and (c) Rs. 210. are shown below.

In all cases, current price of material (Rs. 80) is less than material cost Rs. 100

Case (a): Selling price =Rs. 195

Incremental revenue =Rs. 195 –Rs. 120 =Rs. 75

Current price of material =Rs. 80

It is better to not to make the product.

Net realisable value =Rs. 80

Cost of material =Rs. 100
Value of inventory =Rs. 80
Case (b): Selling price =Rs. 230
Incremental revenue =Rs. 230 –Rs. 120 =Rs. 110
Current price of material =Rs. 80
It is better to make the product.
Net realisable value =Rs. 110
Cost of material =Rs. 100
Value of inventory =Rs. 100
Case (c): Selling price =Rs. 210
Incremental revenue =Rs. 210 –Rs. 120 =Rs. 90
Current price of material =Rs. 80
It is better to make the product.
Net realisable value =Rs. 90
Cost of material =Rs. 100
Value of inventory =Rs. 90

COMPARISON OF COST AND NET REALISABLE VALUE

- **The comparison between cost and net realisable value should be made on item-by-item basis. except where it is appropriate to group similar or related items.**

Question (may 2004)

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 2010-11, the Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

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

What will be the value of closing stock?

Answer:- For calculating the value of stock, each item is to be reviewed individually. The valuation of stock is to be done as follow:

Items	Historical Cost (₹ in lakhs)	Net Realisable Value (₹ in lakhs)	Valuation of closing stock (₹ in lakhs)
A	40	28	28
B	32	32	32
C	16	24	16
	88	84	76

Hence, closing stock will be valued atRs.76 lakhs.

VALUATION OF JOINT STOCK, BY PRODUCTS AND SCRAP

A production process may result in more than one product being produced simultaneously.

When a group of individual products is simultaneously produced, and each product has significant relative sales volume, the outputs are usually called **Joint Products.**

Those products which are part of the simultaneous production process and have a minor sales volume or in insignificant sales volume are called **BY-Products.**

In case of joint products, when the cost of conversion of each products are not separately identifiable, they are allocated between the products on a rational and consistent basis. The joint cost may be allocated on the basis of relative sales value of each product, either when they complete or when they are separately identifiable in the production process.

Most by-products as well as scrap or waste material, by its nature, is immaterial. If this is the case, then it is measured at net realizable value, and this value is deducted from the cost of main product.

E.g. 5000 units of Exe and 2500 units of Wye arise jointly from a production process, involving a total cost of Rs. 2,60,000. If the sales value at split off point is Rs. 100 & Rs. 60 respectively for the products Exe and Wye, explain how the total joint cost conversion will be allocated to the products

Solution

Particulars	Exe	Wye	Total
Quantity	5000 units	2500 units	7500 units
Sale Price per Unit	100	60	
Total Sales Value	500000	150000	650000
Joint Cost Apportioned (on the basis of Sale Value)	200000	60000	260000
Cost of Conversion per Unit	40	24	

E.g. During the production of Main Product Bomax, a by-product brucil is also produced. Cost of conversion is Rs. 385000. 125000 units of Bomax and 7500 units of brucil arise from the process. Brucil has to produced further as Rs. 0.80 per unit after which it can be sold for Rs. 4.80 per unit . Calculate the cost of conversion of Bomax and Brucil.

Solution

Joint Cost of Bomax & Brucil		Rs. 385000
NRV of By product Brucil	(Rs. 4.80 - Rs. 0.80) x75000 units	Rs. 30000
Net Joint cost of Bomax	(385000-30000)	Rs. 355000
Cost of Conversion of Main Product	(Rs. 355000/125000 units)	Rs. 2.84 per unit

DISCLOSURE REQIREMENTS

- **Accounting policies adopted in measuring inventories.**
- **Cost formula used.**
- **Total carrying amount of inventories.**
- **Classification of the above into raw materials and components, work in progress, finished goods, stores and spares, Traded Goods and loose tools & Other (nature to be specified).**

Question (CA- Nov. 2000)

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 stock 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 stock 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 stock 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 stock of 10,000 kgs of raw material will be valued at ₹ 80 per kg. The finished goods, if on stock, should be valued at cost or net realisable value whichever is lower.

(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 ₹ 50,000 (50 MT x ₹ 1,000) will be charged in the profit and loss statement.

(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 $\left(\frac{₹\ 10,00,000}{1,00,000}\right)$	10
	140

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

AS-3

CASH FLOW STATAEMENTS

PURPOSE

- To provide information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement.
- Classification of cash flows into operating, investing and financing activities.

SCOPE

An enterprise should prepare a cash flow statement and present the same along with the financial statements for each period.

RELEVANT DEFINITIONS

- **Cash** comprises cash on hand and demand deposits with banks.
- **Cash equivalents** are short term, highly liquid investments that are readily convertible into known amounts of cash.
- **Cash flows** are inflows and outflows of cash and cash equivalents.
- **Operating activities** are the principal revenue-producing activities of the enterprise other than investing or financial activities.
- **Investing activities** are the acquisition and disposal of long-term assets.
- **Financing activities** are activities that result in changes in the size and composition of the owner's capital (including preference share capital in the case of a company) and borrowings of the enterprise.

PRESENTATION OF THE CASH FLOW STATEMENT

- The cash flow statement should report cash flows during the period.
- The cash flows have to be classified activity-wise into operating, investing and financing activities.

CASH FLOW FROM OPERATING ACTIVITIES

EXAMPLES:

- Cash receipts from customers, royalties, fees, commission, and other revenue.
- Cash payments to suppliers for goods and services.

- Cash payments to and on behalf of employees.

CASH FLOW FROM INVESTING ACTIVITIES

EXAMPLES:

- cash payments to acquire fixed assets.
- cash receipts from disposal of fixed assets
- Interest & dividend received

CASH FLOW FROM FINANCING ACTIVITIES

- Proceeds from issue of share capital.
- Proceeds from long term borrowings.
- Repayment of long term borrowings.

Question 1

X Ltd. purchased debentures of ₹ 10 lacs of Y Ltd., which are traded in stock exchange. How will you show this item as per AS 3 while preparing cash flow statement for the year ended on 31st March, 2011?

Answer

As per AS 3 on 'Cash flow Statement', cash and cash equivalents consists of cash in hand, balance with banks and short-term, highly liquid investments[2]. If investment, of ₹ 10 lacs, made in debentures is for short-term period then it is an item of 'cash equivalents'.

However, if investment of ₹ 10 lacs made in debentures is for long-term period then as per AS 3, it should be shown as cash flow from investing activities.

Question 2 *(2 Marks) (May, 2007)*

Garden Ltd. acquired fixed assets viz. plant and machinery for Rs.20 lakhs. During the same year it sold its furniture and fixtures for Rs.5 lakhs. Can the company disclose, net cash outflow towards purchase of fixed assets in the cash flow statement as per AS-3?

Answer

According to Para 21 of AS 3 (Revised) 'Cash Flow Statements', an enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described in paragraphs 22 and 24 are reported on a net basis. Acquisition and disposal of fixed assets is not prescribed in para 22 and 24 of the standard.

Hence, the company cannot disclose net cash flow in respect of acquisition of plant and machinery and disposal of furnitures and fixtures.

AS - 7

ACCOUNTING FOR CONSTRUCTION CONTRACTS

PURPOSE

The standard prescribes the accounting treatment of revenue and costs relating to construction contracts, in different accounting periods in which construction work is performed.

CONSTRUCTION CONTRACT

A construction contract is one, by which a contractor agrees to build some asset(s) for his customer.

A construction contract is a contract for the construction of a single asset or of a combination of assets which together constitute a single project

Construction contracts include:

(a) Contracts for the rendering of services which are directly related to the construction of the asset,

For example, those for the services of project managers and architects; and

(b) Contracts for destruction or restoration of assets, and the restoration of the environment.

e.g. L&T Ltd. has received a contract for the construction of bridge over Hooghly river near Kolkata. For the construction of new bridge, the old existing bridge is to be demolished. This demolition is a part of the bridge contract.
e.g. Your company HRBC Ltd. is constructing a new 6 Lane highway in behalf of Highway Authority of India. A clause in the contract requires that on both the sides of the highway, three rows of trees are to be planted at the cost of the company. This is a part of the highway contract.

TYPES OF CONTRACTS

1. **Fixed price contracts.** In this type of contract, price is usually fixed in advance (i.e. before starting contract work.) As per agreement between parties, any additional

work may be charged separately. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations (i.e. due to rise of materials or wages etc.)

2. **Cost plus contracts.** Cost plus contract is a contract in price is not fixed in advance. This type of contract is entered into when it is impossible to calculate future price or cost with reasonable accuracy because of lack of past records and experience e.g. digging of an oil well. The contract price is ascertained later by adding fixed percentage of profit to the cost of the contract.

Combining and Segmenting Construction Contracts

When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when there are separate proposals, separate negotiation, identifiable costs and revenues of each asset.

e.g. Jindal Steel Co. Ltd. is putting a new steel plant in west Bengal. L & T Ltd. the contractor has submitted three separate bids for the following:
(a) Blast Furnace Rs. 600 crore
(b) Captive Power Plant Rs. 100 crore
(c) Conveyor Belt Rs. 20 crore.
Each one of above should be treated as separate contract.

A group of contracts, whether with a single customer or with several customers, is treated as a single construction contract when they are negotiated as a single package, contracts are closely interrelated with an overall profit margin, contracts are performed concurrently or in a continuous sequence.

Question RTP Nov. 2010

X Co negotiates with Indian Oil for construction of "franchisee retail petrol, outlet stations". Based on proposals submitted to different Zonal offices of Indian Oil, the final approval for one outlet each in Berhampore, Salem, Vadodara and Warangal is awarded to X Co. Agreement (in single document) is entered into with Indian Oil for Rs.245 lacs. The agreement lays down values for each of the four outlets (Rs. 44 + 66 + 80 + 55 lacs) in addition to individual completion time. Comment whether X Co. will treat it as a single contract or four separate contracts?

Answer

In this situation, each asset will be treated as a "single contract not withstanding the fact that there is only one document of contract. Four contract accounts have to be recorded in the books of X Co. For each contract account, principles of revenue and cost recognition have to be applied separately, and net income determined for each asset.

Revenue includes initial contract price, variations in contract work, incentives payment, claims etc., and **cost** includes direct cost, attributable cost and specifically chargeable to the customer.

Question RTP Nov.2012

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

Answer

As per Revised AS-7 incentive payments are additional amounts payable to the contractor if specified performance standards are met. A contract may allow for an incentive payment to the contractor for early completion of the contracts. Incentive payments are included in contracts revenue when the contract is sufficiently advanced that it is probable that the specified performance standards will be met and the amount of the incentive payment can be measured reliably. In the given problem, the contracts is not even begun and hence the contractor should not recognise any revenue of this account

METHODS FOLLOWED

The method of accounting selected represents an accounting policy and therefore if there is any change in the accounting policy the effect of the change and its amount needs to be disclosed.

(I) PERCENTAGE OF COMPLETION METHOD

(II) COMPLETED CONTRACT METHOD

PERCENTAGE OF COMPLETION METHOD

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

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

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

MEASUREMENT OF COMPLETION

TAKING INTO ACCOUNT ALL RELEVANT FACTORS

1. The proportion that costs incurred to date bear to the estimated total costs of the contract.
2. By the surveys which measure work performed.
3. Completion of a physical portion of work

Note:- If the cost to date plus estimated cost to complete the contract exceed the contract revenue, then the difference will be considered as loss, which shall be accounted as expenditure immediately.

e.g.

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data.

	₹ 000
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

Solution

	₹ 000
A. Cost incurred to date	390
B. Estimate of cost to completion	260
C. Estimated total cost	650
D. Degree of completion (A/C)	60%
E. Revenue Recognized (60% of 600)	360
Total foreseeable loss (650 – 600)	50
Less: Loss for current year (E – A)	30
Expected loss to be recognised immediately	20

Profit & Loss A/c

	₹		₹
To Construction costs	390	By Contract Price	360
To Provision for loss	20	By Net Loss	50
	410		410

Question RTP Nov.2011

Galaxy Ltd., has signed on 31st Dec, 2010, the Balance Sheet date, a contract where the total revenue is estimated at ₹ 15 crores and total cost is estimated at ₹ 20 crores. No work began on the contract. Is contractor required to give any accounting effect for the year ended December, 31st 2010 in his accounts?

Answer

As per para 35 of AS 7 'Construction Contracts, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. The amount of such loss is determined irrespective of whether or not work has commenced on the contract. Thus, Galaxy Ltd. should recognize loss amounting ₹5 crores for the year ended 31st December, 2010. The contract should be reviewed at the end of the each accounting period for additional losses to be incurred, if any.

Question RTP MAY 2010

A company took a construction contract for Rs.100 lakhs in January, 2006. It was found that 80% of the contract was completed at a cost of Rs.92 lakhs on the closing date i.e. on 31.3.2007. The company estimates further expenditure of Rs.23 lakhs for completing the contract. The expected loss would be Rs.15 lakhs. Can the company recognise the loss in the financial statements prepared for the year ended 31.3.2007?

Answer

As per paragraphs 31 and 35 of AS 7 on Construction Contracts, an expected loss on the construction contract should be recognized as an expense immediately irrespective of (i) whether or not the work has commenced on the contract; or (ii) the stage of completion of the contract; or (iii) the amount of profits expected to arise in other contracts.

Hence, the company must recognize the loss immediately

Question (Ca-Inter Adapted)

M/s Excellent Construction Company Limited undertook a contract to construct a building for ₹ 3 crore on 1st September, 2011. On 31st March, 2012 the company found that it had already spent ₹ 1 crore 80 lakhs on the construction. Prudent estimate of additional cost for completion was ₹ 1 crore 40 lakhs. What amount should be charged, to revenue in the final accounts for the year ended on 31st March, 2012, as per the provisions of Accounting Standard 7 "Construction Contracts (Revised)"?

Answer

	₹ in crores
Cost of construction incurred till date	1.80
Add: Estimated future cost	1.40
Total estimated cost of construction	3.20

Percentage of completion till date to total estimated cost of construction

$$= (1.80/3.20)\times 100 = 56.25\%$$

Proportion of total contract value recognised as revenue as per AS 7 (Revised)

= Contract price x percentage of completion

= ₹ 3 crores x 56.25% = ₹ 1.6875 crores

Amount of foreseeable loss	*(₹ in crores)*
Total cost of construction	3.20
Less: Total contract price	(3.00)
Total foreseeable loss to be recognized as expense	0.20

According to 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.

COMPLETED CONTRACT METHOD

Revenue is recognised only when the contract is completed or substantially completed

Costs and progress payments received are accumulated during the course of the contract but revenue is not recognised until the contract activity is substantially completed.

DISCLOSURE

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

ACCOUNTING STANDARD-9

REVENUE RECOGNITION

PURPOSE

This standard explains when the revenue should be recognized in profit and loss account and also states circumstances in which revenue recognition can be postponed.

REVENUE:-

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from (a) the sale of goods, (b)the rendering of services, and (c) from the use by others of enterprise resources yielding interest, royalties and dividends.

REVENUE RECOGNITION IN SALE OF GOODS

It is recognized when all the following conditions are fulfilled:-

- The property in goods is transferred for a price.
- All significant risks and rewards have been transferred and no effective control is retained.
- No significant uncertainty exists regarding the amount of consideration.
- It is reasonable to expect ultimate collection of consideration.

e.g. computer Point (P) Ltd. sold 10 computers to St. Xavier's College, Kolkata for Rs. 3,00,000 on credit. Here Computer point will recognize the revenue of Rs. 3,00,000 immediately because normal credit risk derived from sales is not a reason to defer revenue recognition.

[**Qus**. Bottom Ltd. entered into a sale deed for its immovable property before the end of the year. But registration was done with registrar subsequent to Balance Sheet date. But before finalization, is it possible to recognize the sale and the gain at the Balance Sheet date? Give your view with reasons. (CA-Final , Nov. 2005)

Answer Yes, . In accordance with AS 9, both sales and gain of Bottom Ltd. should be recognized at the Balance Sheet date and the registration of the property is merely a formality. It is clear that significant risk and rewards of ownership had passed before the balance sheet date.]

[**Qus.** The Board of Directors of X Ltd. decided on 31.3.2011 to increase sale price of certain items of goods sold retrospectively from 1st January, 2011. As a result of this decision the company has to receive Rs.5 lakhs from its customers in respect of sales made from 1.1.2011 to 31.3.2011. But the Company's Accountant was reluctant to make-up his mind. You are asked to offer your suggestion. (CA-Inter Adapted)

Answer As per para 10 of AS 9 'Revenue Recognition', the additional revenue on account of increase in sales price with retrospective effect, as decided by Board of Directors of X Ltd., ofRs.5 lakhs to be recognised as income for financial year 2010-11, only if the company is able to assess the ultimate collection with reasonable certainty. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

[**Qus.** A claim lodged with the Railways in March, 2010 for loss of goods of Rs. 2,00,000 had been passed for payment in March, 2012 forRs. 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. (CA-Final Adapted)

Answer Since the amount has been received, revenue is measurable. Therefore, the company should recognize in the current year (2012) as part of net income. The company was correct in not providing for the same as revenue in 2010, when the claim was logded.

[**Qus.** SM company has taken a Transit Insurance Policy. Suddenly in the year 2011-2012 the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2011-2012 in accordance with relevant Accounting Standards. Do you agree? Explain in brief, as per the relevant Accounting Standards.(CA-Final, may 2003)

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

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

REVENUE RECOGNITION IN RENDERING OF SERVICES

Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

- **Completed service method** Revenue is recognised when service is about to be completed and no significant uncertainties exist about the collection of amount of service charges.
- **Proportionate completed method** Recognises revenue proportionate with the degree of completion of services. In such cases there are more than one act involved and revenue is recognised on execution of certain acts. no significant uncertainties exist about the collection of amount of service charges.

e.g. your company Hindustan Constructing Co. Ltd. (HCCL) is laying a city gas pipe line for its client REL. Total revenue of the project is Rs. 40,00,000.
HCCL has incurred cost up to 31st March, 2008 Rs. 15,00,000 and the company is expecting that Rs. 10,00,000 more will be required to complete the project.
Upto 31st December, 2007 REL has approved Rs. 12,50,000 of expenditure. HCCL is confident that the balance Rs. 2,50,000 (Rs. 15,00,000-Rs.12,50,000) will be approved by RELwhen their engineer will inspect the work during the 1st week of April, 2008. No payment has been received so far.
Recognise :
(a) Rs. 12,50,000 as expenses (the amount approved)
(b) Rs. 20,00,000 as (accrued) revenue
(Rs. 12,50,000/Rs.25,00,000) x Rs. 40,00,000

REVENUE RECOGNITION IN USE OF ENTERPRISE RESOURCES BY OTHERS

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should be recongnised when no significant uncertainty as to measurablility or collectability exists.

- <u>**Interest**</u> Revenue from interest should be recognized on time proportion basis.

[**Qus.** Arjun Ltd. sold farm equipments through its dealers. One of the conditions at the time of sale is payment of consideration in 14 days and in the event of delay interest is chargeable @ 15% per annum. The Company has not realized interest from the dealers in the past. However, for the year ended 31.3.2011, it wants to recognise interest due on the balances due from dealers. The amount is ascertained at Rs. 9 lakhs. Decide, whether the income by way of interest from dealers is eligible for recognition as per AS 9? (CA-Inter Adapted)

Answer As per AS 9 "Revenue Recognition", where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty inverted. In such cases, the revenue is recognized only when it is reasonably certain that the ultimate collection will be made.

In this case, the company never realized interest for the delayed payments make by the dealers. Hence, it has to recognize the interest only if the ultimate collection is certain. The interest income hence is not to be recognized.]

[**Qus.** 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? (CA-Final May 2003)

Answer Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should be recongnised when no significant uncertainty as to measurablility or collectability exists. Revenue from interest should be recognized on time proportion basis.

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

- **Royalty** : on accrual basis as per terms of agreement.

[**Qus.** Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. receivedRs. 10 lakhs andRs.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. (CA-Final, May 1999)

Solution As per 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.]

- **Dividends**: when the declaring company declares dividend.

[**Qus.** X Limited has recognized Rs.10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of Rs. 50 lakhs held by it as at the end of the financial year 31st March, 2011. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2011. The dividend was proposed on 10th April, 2011 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.(*CA-Inter Adapted*)]

Answer Paragraph 8.4 and 13 of Accounting Standard 9 'Revenue Recognition' states that dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established. In the given case, the dividend is proposed on 10th April, 2011, while it is declared on 15th June, 2011. Hence, the right to receive payment is established on 15th June, 2011. As per the above mentioned paragraphs, income from dividend on units of mutual funds should be recognised by X Ltd. in the financial year ended 31st March, 2012.

The recognition of Rs.10 lakhs on accrual basis in the financial year 2010-2011 is not as per AS 9 'Revenue Recognition'.

DISCLOSURE REQUIREMENTS

When recognition of revenue is postponed due to the effect of uncertainties, an enterprise should disclose the circumstances in which revenue recognition has been postponed.

AS - 13

ACCOUNTING FOR INVESTMENTS

PURPOSE: - *Accounting for investments in the financial statements of enterprises and related disclosure requirements.*

Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. **Assets held as stock-in-trade are not 'investments'.**

Classification of Investments

Investments are classified as Long Term Investments and Short Term Investments.

- Current Investment is intended to be held for not more than one year and readily realisable.
- Long term Investment is an investment other than a current investment.

COST OF INVESTMENTS

-The cost of an investment includes acquisition charges such as brokerage, fees and duties.

FOR EXAMPLE , X LTD. PURCHASED 10,000 SHARES @ Rs.120 each and paid brokerage @2%

The acquisition cost of the investment is as under:

Cost of shares (10,000XRs.120)	Rs. 1,20,000
Add: Brokerage (2% on Rs. 1,20,000)	Rs. 2,400
Cost of acquisition	Rs. 1,22,400

-In case of investments acquired in **exchange of securities** etc., investments shall be recorded at **fair value** of the securities issued.

e.g. X Ltd. acquired 10,000 shares of Rs. 100 each (market value Rs. 130 each) in Y Ltd. by the issue of its 10,000 share-face value and market value per share being Rs. 100 and Rs. 120 respectively. To ascertain the cost of the investment, in such a case, market value of the shares issued is to be considered. Therefore, the value of the investments is 10,000 x Rs. 120 = Rs. 1,20,000

-In case, investments were bought by **exchange of another asset**, the acquired investment shall be recorded at the fair value of the asset given up. It will be appropriate to consider **fair value** of the investments bought if it is more clearly evident.

e.g. X Ltd. acquired 10,000 shares of Rs. 100 each (market value Rs. 120 each) in exchange for a machinery (WDV Rs. 90,000 and market value of Rs. 1,10,000). The cost of investment in this case, would be either the fair value of the shares acquired, i.e. Rs. 1,20,000 or the fair value of the machinery given up, i.e. Rs. 1,10,000-which is more clearly evident.

INCOME FROM INVESTMENTS

Interest, dividend and rentals receivable in respect of such investments are treated as income except where such interest or dividend relates to pre-acquisition period, in which case, such interest or dividend received is reduced from the acquisition cost.

e.g. On 1st April, 2008 X Ltd. purchased 2000, 12% debentures of Rs. 100 each @ Rs. 98 (cum-interest). Debenture interest is payable half yearly on 30th June and 31st December. Date of closing the books of account is 31st December every year, Cost and accrued interest are to be calculated as follow:

Step 1: calculation of period (in months) – From 1.1.2008 to 31.3.2008 = 3 months

Step 2: Accrued interest = 12% x 3/12 x Rs. 2,00,000 = Rs. 6000.

Step 3: Cost [(Rs. 98 x 2,000) less Rs. 6,000 = Rs. 1,96,000-Rs. 6,000 = Rs. 1,90,000

Rights Share

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding.

If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement.

Where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

For *e.g.*, Mr. X acquires 200 shares of a company on cum-right basis for ₹ 50,000. He subsequently receives an offer of right to acquire fresh shares in the company in the proportion of 1:1 at ₹ 110 each. X subscribes for the right issue. Thus, the total cost of X's holding of 400 shares would amount to ₹ 72,000.

Suppose, he does not subscribe but sells the rights for ₹ 15,000. The ex-right market value of 200 shares bought by X immediately after the rights falls to ₹ 40,000. In this case out of sale proceeds of ₹ 15,000, ₹ 10,000 may be applied to reduce the carrying amount to the market value ₹ 40,000 and ₹ 5,000 would be credited to the profit and loss account.

Investment properties

The cost of any shares in co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property. <u>(Such Investment Property is to be valued as per cost model of PPE as per AS-10.)</u>

e.g. X Ltd. purchased a flat from a co-operative society for Rs. 50,00,000 it will be rented out to other company to obtain the membership of the society. X Ltd. had to purchase 1,000 shares of Rs. 100 each of the society. The cost of acquisition of this investment property becomes Rs. 50,00,000 + Rs. 1,00,000. = Rs. 51,00,000.

Carrying Amount of Investments

The carrying amount for **current investments** is the lower of cost and fair value. Valuation of current investments on overall basis is not considered appropriate. The more prudent and appropriate method is to carry investments **individually at the lower of cost and fair value**.

Reduction and reversals of current investments shall be done through profit and loss account.

Long-term investments are to be valued at **cost**. <u>(Valued as per cost model of PPE as per AS-10)</u> It can be reduced to a lower value (i.e. by making provision for reduction individually) if the fall in the value of investment is permanent. It can also be reversed if the reason for the fall is no longer in existence.(i.e. value of investment rises)

e.g. An unquoted long term investment is carried in the books at its cost of Rs.5 lakhs. The Published Accounts of the unlisted company received in May, 2010 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs.80, 000. State with reasons, how you would deal with them in the Financial Statements. (RTP Nov. 2011) **Answer** 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 this basis, 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 Rs. 80,000 in the financial statements for the year ended 31st March, 2010.

Question

A manufacturing company purchased shares of another company from stock exchange on 1st May, 2007 at a cost of Rs.5,00,000. It also purchased Gold of Rs.2,00,000 and Silver of Rs.1,50,000 on 1st April, 2005. How will you treat these investments as per the applicable AS in the books of the company for the year ended on 31st March, 2008, if the values of these investments are as follows:

	Rs.
Shares	2,00,000
Gold	4,00,000
Silver	2,50,000

Answer

As per para 32 of AS 13 on 'Accounting for Investments', any investment of long term period is shown at cost. Hence, the investment in Gold and Silver (purchased on 1st April 2005) shall continue to be shown at cost i.e., Rs.2,00,000 and Rs.1,50,000 respectively as their value have increased.

Also as per AS 13, for investment in shares - if the investment is for short-term period then the loss of Rs.3,00,000 is to be charged to profit & loss account for the year ended 31st March, 2008. If investment is of long term period then it will continue to be shown at cost in the Balance Sheet of the company. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

DISPOSAL OF INVESTMENTS

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

partial disposal When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

RECLASSIFICATION OF INVESTMENTS

12. When there is a reclassification of long term investment into current investment, it should be valued at lower of cost and the carrying amount. If the opposite is to happen, it shall be valued at **lower of cost and the fair value whichever is lesser on the date of reclassification.**

E.g.

'Suram' Ltd. wants to re-classify its Investment in accordance with AS 13. Decide on the treatment to be given in each of the following cases:

(1) A portion of Current Investments purchased for ₹ 20 lakhs to be reclassified as long-term Investments, as the company has decided to retain them. The market value as on the date of Balance Sheet was ₹ 25 lakhs.

(2) Another portion of Current Investments purchased for ₹ 15 lakhs has to be re classified as Long-term Investments. The market value of these investments as on the date of Balance Sheet was ₹ 6.5 lakhs.

(3) Certain Long-term Investments no longer considered for holding purposes have to be re-classified as Current Investments. The original cost of these was ₹ 18 lakhs but they had been written down to ₹ 12 lakhs to recognize permanent decline as per AS 13.

Answer

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

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

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

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

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

DISCLOSURES

a. Accounting policies adopted for determination of carrying amount.

b. Classification of Investments

c. The amounts included in profit and loss statement for:

I. The amounts included in profit and loss statement for interest, dividends, rentals,profits and losses on disposal of investments

ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.

iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.

d. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.

e. The aggregate amount of quoted and unquoted investments,

f. Other disclosures as specifically required by the relevant statute.

Example (RTP May 2012)

Albert Finance Ltd. has made the following investments:

(i) Purchased the following equity shares from stock exchange on 1st June, 2010:

	Cost ₹
Scrip X	1,80,000
Scrip Y	50,000
Scrip Z	1,70,000
	4,00,000

(ii) Purchased gold of ₹ 3,00,000 on 1st April, 2007.

(iii) Invested in mutual funds at a cost of ₹ 6,00,000 on 31st March, 2010.

(iv) Purchased government securities at a cost of ₹ 5,00,000 on 1st April, 2010.

How will you treat these investments as per applicable AS in the books of the company for the year ended on 31st March, 2011, if the values of these investments are as follows:

Shares	₹	₹
Scrip X	1,90,000	
Scrip Y	40,000	
Scrip Z	70,000	3,00,000
Gold		5,00,000
Mutual funds		4,50,000
Government securities		7,00,000

Also explain is it possible to off-set depreciation in investment in mutual funds against appreciation of the value of investment in government securities?

(Hint: Para 14, 15 & 17 of AS 13)

Answer

As per para 14 & 15 of AS 13 'Accounting for Investments', current investments should be carried at lower of cost and fair price determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis. Also as per para 17 of the standard, long-term investments are carried at cost except when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline.

(i) If the investment in shares is intended to be held for not more than one year from the date on which such investment is made then scrip X should be valued at cost i.e. ₹1,80,000 (lower of cost and fair value), scrip Y should be valued at fair value i.e. ₹40,000 (lower of cost and fair value) and scrip Z should be valued at fair value i.e. ₹70,000 (lower of cost and fair value). The total loss of ₹ 1,00,000 (₹ 4,00,000 – ₹ 3,00,000) on scrip's purchased on 1st June, 2010 is to be charged to profit and loss account for the year ended 31st March, 2011.

If investment is intended to be held for long term period then it will continue to be shown at cost in the balance sheet of the company. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of investments, such reduction being determined and made for each investment individually.

(ii) The investment in gold (purchased in April, 2007) shall continue to be shown at cost of ₹3,00,000 in the balance sheet as on 31.3.2011.

(iii) If mutual funds are intended to be held for short term period then, it will be valued at ₹4,50,000 as on 31st March, 2011 and if it is intended to be held for long term then it should be valued at its cost i.e. ₹6,00,000.

(iv) Value of government securities (purchased on 1st April, 2010) is to be shown at cost of ₹ 5,00,000 in the balance sheet as on 31.3.2011.

Inter-category adjustments of appreciation and depreciation in value of investments cannot be done. It is not possible to offset depreciation in investment in mutual funds against appreciation in value of investments in government securities.

AS- 14

ACCOUNTING FOR AMALGAMATIONS

PURPOSE

- **Accounting for amalgamations,**
- **Treatment of any resultant goodwill or reserves.**

TYPES OF AMALGAMATIONS

- **NATURE OF MERGER**
- **NATURE OF PURCHASE**

CONDITIONS FOR NATURE OF MERGER

- All the assets and liabilities are transferred;
- Shareholders holding not less than 90% of the face value of the equity shares of the transferor company become shareholders of transferee company;
- The consideration is discharged by the issue of equity Shares in the transferee company;
- The business of the Transferor Company is intended to be carried on; &
- No adjustment to be made to the book values of the assets and liabilities.

[Briefly explain the methods of accounting for amalgamation as per Accounting Standard-14.(CA-Inter Adapted)]

[List the conditions to be fulfilled as per Accounting Standard 14 for an amalgamation to be in the nature of merger, in the case of companies. .(CA-Inter Adapted)]

ACCOUNTING TRATMENT

1. There are two methods of accounting in the books of Transferee Company. They are (a) Amalgamation in the nature of purchases (b) amalgamation in the nature of merger.

2. In case of amalgamation in the nature of purchases, the difference between the net asset value of the transferor company and the purchase consideration shall be identified as goodwill/capital reserve. For similar situation in case of amalgamation in the nature of merger, the difference will be transferred to profit and loss account or general reserve.

3. The benefit derived in case of amalgamation in the nature of merger is to protect the entire net asset value of the transferor company in the books of merged entity including the reserves and surplus. The name of the accounting treatment followed for amalgamation in the nature of merger is pooling of interest method. For amalgamation in the nature of purchases, it is referred to as purchases method.

4. In case of amalgamation in the nature of purchases, <u>Amalgamation Adjustment Reserve Account</u> shall be debited for creating the statutory reserve of the transferor company in the merged entity & <u>the Amagamation Adjustment Reserve Account will be shown as a separate item in the balance sheet as per schedule III of Companies Act,2013.</u> This requirement is not felt under pooling of interest method as the entire reserves and surplus of Transferor Company are protected when the net assets are incorporated in the books of the merged entity.

DISCLOSURES

<u>FIRST YEAR - BOTH NATURES OF AMALGAMATION</u>

- names and general nature of business of the amalgamating companies;
- effective date of amalgamation for accounting purposes;
- the method of accounting used to reflect the amalgamation; and
- particulars of the scheme sanctioned under a statute.

<u>FROM SECOND YEAR</u>

<u>Pooling of Interests method</u>

(a) Description and number of shares issued,

(b) The amount of any difference between the consideration and the value of net assets acquired

<u>Purchase method</u>

(a) A description of the consideration paid or payable;

(b) Any difference between the consideration and the value of net assets acquired.

[Briefly describe the disclosure requirements for amalgamation including additional disclosure, if any, for different methods of amalgamation as per AS 14. (CA Inter Adapted)]