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Accounting Standards and Guidance Notes

UNIT 1: INTRODUCTION TO ACCOUNTING STANDARDS

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statements.

1.1 Objectives of Accounting Standards

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true state of affairs. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards provide framework and standard accounting policies so that the financial statements of different enterprises become comparable.

The Accounting Standards reduce the accounting alternatives in the preparation of rational financial statements thereby ensuring comparability of financial statements of different enterprises. The Accounting Standards deal with the issues of

(i) recognition of events and transactions in the financial statements,

(ii) measurement of these transactions and events,

(iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and

(iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into these financial statements which helps the users to take prudent and informed business decisions.

The objective of Accounting Standards is to standardize diverse accounting policies with a view to eliminate, to the maximum possible extent,

(i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and

(ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements.

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The concept of Accounting Standards and the standards setting process in India has already been discussed, in detail, in IPCC Accounting Study Material – Chapter 1.

1.2 Benefits and Limitations

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards the accountant has following benefits:

(i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.

(ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

(iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

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

(i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

(ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.

(ii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

1.3 Standard-Setting Process

The need for accounting standards specifically suitable for the country's economic environment was also felt in India. Recognising the need to harmonise the diverse accounting policies and practices in India and keeping in view the international developments in the field of accounting, the Council of the Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) on 21st April, 1977. The composition of ASB is broad based to ensure due representation and the participation of all those who are interested in the formulation and implementation of these standards. Apart from the elected members of the Council of the ICAI nominated on the ASB, there are various Central Government nominees, nominees from various other professional institutes like the Institute of Cost and Works Accountants of India, Institute of Company Secretaries of India, Representatives of Industry Associations, Reserve Bank of India, Securities and Exchange Board of India, Controller General of Accounts, Central Board of Excise and Customs, Representative of Academic and Financial Institutions, other eminent professionals co-opted by the ICAI and any representative(s) of other body, as considered appropriate by the ICAI.

The preliminary drafts of the standards are prepared by the Study Groups which take up specific subjects assigned to them. The draft so prepared is considered by ASB and sent to various outside bodies like FICCI, ASSOCHAM, SCOPE, CLB, C & AG, ICWAI, ICSI, CBDT etc. After taking into consideration their views, the draft of the standards is issued as an Exposure Draft (ED) for comments by members of ICAI and the public at large. The comments on the ED are considered by ASB and a final draft of the standard is submitted to the Council of the ICAI for its approval and is thereafter issued as a definitive standard.

1.4 How Many Accounting Standards?

The council of the Institute of Chartered Accountants of India has, so far, issued thirty two Accounting Standards. However, AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are 31 Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.5 Applicability of Accounting Standards

For the purpose of compliance of the accounting Standards, the ICAI had earlier issued an announcement on 'Criteria for Classification of Entities and Applicability of Accounting Standards'. As per the announcement, entities were classified into three levels. Level II entities and Level III entities as per the said Announcement were considered to be Small and Medium Entities (SMEs).

However, when the accounting standards were notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards, the Central Government also issued the 'Criteria for Classification of Entities and Applicability of Accounting Standards' for the companies. It is pertinent to note that the accounting standards notified by the government were mandatory for the companies since it was notified in pursuant to sections 211(3C) of the Companies Act, 1956.

According to the 'Criteria for Classification of Entities and Applicability of Accounting Standards' as issued by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Companies (Accounting Standards) Rules, 2006 and companies other than SMCs. Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs.

Consequent to certain differences in the criteria for classification of the levels of entities as issued by the ICAI and as notified by the Central Government for companies, the Accounting Standard Board of the ICAI decided to revise its ''Criteria for Classification of Entities and Applicability of Accounting Standards' and make the same applicable only to non-corporate entities. Though the classification criteria and applicability of accounting standards has been largely aligned with the criteria prescribed for corporate entities, it was decided to continue with the three levels of entities for non-corporate entities vis-à-vis two levels prescribed for corporate entities as per the government notification.

'Criteria for Classification of Entities and Applicability of Accounting Standards' for corporate entities and non-corporate entities have been explained in the coming paragraphs.

No relaxation was given to Level II and III enterprises in respect to recognition and measurement principles. Relaxations were provided with regard to disclosure requirements.

1.5.1 Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees *one crore** but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

(1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

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* *This change is made as per the announcement 'Revision in the criteria for classifying Level II non-corporate entities' issued by the ASB on 7.3.2013. This revision is applicable with effect from the accounting year commencing on or after April 01, 2012.*

(6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard: Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

(7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

1.5.2 Criteria for classification of Companies under the Companies (Accounting Standards) Rules, 2006: Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

"Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non- SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-

   1.1 The SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

   "The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the

Companies Act Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B Other Instructions

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

"5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods."

1.5.3 Applicability of Accounting Standards to Companies

1.5.3.1 Accounting Standards applicable to all companies in their entirety for accounting periods commencing on or after 7th December, 2006

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets

AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 22	Accounting for Taxes on Income
AS 24	Discontinuing Operations
AS 26	Intangible Assets

1.5.3.2 Exemptions or Relaxations for SMCs as defined in the Notification

(A) Accounting Standards not applicable to SMCs in their entirety:

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

(B) Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs[*]*:*

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in

[*] AS 21, AS 23 and AS 27 (relating to consolidated financial statements) are required to be complied with by a company if the company, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.

(iii) AS 20, Earnings Per Share

Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.

(iv) AS 28, Impairment of Assets

SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.

(D) AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.

1.5.4 Applicability of Accounting Standards to Non-corporate Entities

1.5.4.1 Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories

AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 22	Accounting for Taxes on Income
AS 26	Intangible Assets

1.5.4.2 Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

AS 3	Cash Flow Statements
AS 17	Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

AS 3	Cash Flow Statements
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 24	Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities:

(i)	AS 21, Consolidated Financial Statements
(ii)	AS 23, Accounting for Investments in Associates in Consolidated Financial

	Statements
(iii)	AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(D) Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(1) Level II and Level III Non-corporate entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down inparagraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to non-corporate entities falling in Level II . Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III entities.

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to noncorporate entities falling in Level II and Level III.

(E) *AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.*

1.6 List of Accounting Standards

Following is the list of Accounting Standards with their respective date of applicability:

AS No.	*AS Title*	*Date*
1	Disclosure of Accounting Policies	01/04/1993
2	Valuation of Inventories (Revised)	01/04/1999
3	Cash Flow Statement (Revised)	01/04/2001
4	Contingencies and Events Occurring	
	after the Balance Sheet Date	01/04/1998
5	Net Profit or Loss for the Period, Prior Period	
	Items and Changes in Accounting Policies (Revised)	01/04/1996
6	Depreciation Accounting (Revised)	01/04/1995
7	Construction Contracts (Revised)	01/04/2002
8	Research & Development	Now included in AS 26
9	Revenue Recognition	01/04/1993
10	Accounting for Fixed Assets	01/04/1993
11	The Effects of Changes in Foreign Exchange Rates (Revised)	01/04/2004
12	Accounting for Government Grants	01/04/1994
13	Accounting for Investments	01/04/1995
14	Accounting for Amalgamations	01/04/1995
15	Employee Benefits	01/04/2006
16	Borrowing Costs	01/04/2000
17	Segment Reporting	01/04/2001
18	Related Party Disclosures	01/04/2001
19	Leases	01/04/2001
20	Earning Per Shares	01/04/2001

21	Consolidated Financial Statement	01/04/2001
22	Accounting for Taxes on Income	01/04/2006
23	Accounting for Investment in Associates in Consolidated Financial Statements	01/04/2002
24	Discontinuing Operations	01/04/2004
25	Interim Financial Statement	01/04/2002
26	Intangible Assets	01/04/2003
27	Financial Reporting of Interests in Joint Ventures	01/04/2002
28	Impairment of Assets	01/04/2008
29	Provisions, Contingent Liabilities and Contingent Assets	01/04/2004
30	Financial Instruments: Recognition and Measurement	01/04/2009 (Recommendatory)
31	Financial Instruments: Presentation	01/04/2009 (Recommendatory)
32	Financial Instruments: Disclosure	01/04/2009 (Recommendatory)

All of the above mentioned standards AS 1 to AS 32 (excluding AS 8) will be discussed in detail in the succeeding units of this chapter.

UNIT 2 : AS 1 : DISCLOSURE OF ACCOUNTING POLICIES

2.1 Introduction

Irrespective of extent of standardisation, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard. Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time. The accounting standards therefore permit more than one accounting policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

During 1979, when ASB was established, the business environment in India was such that enterprises were reluctant to prepare accounting notes, few enterprises used to disclose the important accounting policies but the degree and method of disclosure varies considerably. Some enterprises used to disclose them as part of main financial statement, few others as a supplementary.

Therefore the main aim of this statement is not only to promote disclosure of accounting policies but also to determine that all accounting policies are disclosed at one place as main part of the financial statement.

AS 1 deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements. The purpose of the Standard is to promote better understanding of financial statements by establishing through an Accounting Standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

2.2 Applicability

This AS was issued in 1979 and is now mandatory and applicable for all enterprises.

2.3 Fundamental Accounting Assumptions

The Accounting Standard 1 recognises three fundamental accounting assumptions. These are

(a) Going Concern

(b) Consistency and

(c) Accrual.

So long as these assumptions are followed in preparation of financial statements, no disclosure of such adherence is necessary. Any departure from any of these assumptions should however be disclosed.

(a) Going Concern Assumption: The enterprise is normally viewed as a going concern, i.e. as continuing operations for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or curtailing, materially its scale of operations.

Accordingly, assets and liabilities are recorded on the basis that the enterprise will be able to realise its assets and discharge its liabilities in the normal course of business. If an enterprise is not a going concern, valuation of its assets and liabilities on historical cost becomes irrelevant and as a consequence its profit/loss may not give reliable information.

Example: A Ltd. has proposed to acquire B Ltd. in January, 2013. The acquisition of B Ltd. took place during May 2013, since then B Ltd. is no more a going concern. This fact should be disclosed in the financial statements of B Ltd. for the year ended March 31, 2013.

(b) Accrual Assumption: Revenues and costs are recorded as they are accrued, i.e., revenue items are recognized as they are earned or incurred and recorded in the financial statements of the periods to which they relate even though payment and receipt of actual cash has not been taken place. This assumption is the core of accrual accounting system.

Example: Credit sales of goods on March 01, 2014; money receivable after three months are recognised as sales during the financial year 2013-14 itself and amount due is debited to the customer's account. Similarly, credit purchase of goods is also recorded as purchases during the year when purchase takes place and amount payable is credited to the suppliers account in the year of purchase though the payment is made in the next financial year.

(c) Consistency Assumption: It is assumed that accounting policies are consistent from one period to another. Unless this is done, comparatives are rendered meaningless. If comparability is lost, the relevance of accounting data for users' judgment and decision-making is gone.

Example: If enterprise has opted for written down value method of charging depreciation then in the following years, it should stick to this method only, unless under changed environment it is considered highly inappropriate to continue with it.

2.4 Disclosure of Deviations from Fundamental Accounting Assumptions

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy.

2.5 Accounting Policies

The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

Accountant has to make decisions from various options for recording or disclosing items in the books of accounts e.g.:

Items to be disclosed	*Method of disclosure or valuation*
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method
Depreciation	Straight Line Method, Reducing Balance Method, Depletion Method etc.

This list is exhaustive i.e. endless. For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountant need to form principles and evolve a method to adopt those principles. This method of forming and applying accounting principles is known as accounting policies.

As we say that accounts is both science and art. It is a science because we have some tested accounting principles, which are applicable universally, but simultaneously the application of these principles depends on the personal ability of each accountant. Since different accountants may have different approach, we generally find that in different enterprise under same industry, different accounting policy is followed. Though ICAI along with Government is trying to reduce the number of accounting policies followed in India but still it cannot be reduced to one.

Since accounting policy adopted will have considerable effect on the financial results disclosed by the financial statement, it makes it almost difficult to compare two financial statements.

2.6 Considerations in the Selection of Accounting Policies

The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a **true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.** To ensure the true and fair consideration this statement issues following guidelines:

Prudence: As defined in the statement, prudence means recognising all losses immediately but ignoring anticipated profits. Business environment is highly dynamic, therefore, enterprises has to keep anticipate the future and take managerial decisions accordingly. In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Example: If valuation of inventory is always done at cost, consider a situation where market price of the relevant goods has reduced below the cost price, then valuing inventory at cost price means ignoring anticipated losses. Similarly if inventory is always valued at market price, then take a situation where cost price is below market price, indirectly we are recognising the anticipated gross profit on inventory in the books. Therefore, accounting policy should be cost price or market price whichever is less, in this case we are ignoring anticipated profits (if any) but any anticipated losses would be taken care of.

Substance over form: The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

Example: The ownership of an asset purchased on hire purchase is not transferred till the payment of the last instalment is made but the asset is shown in the books of the hire purchaser. Similarly, in the case of the amalgamation, the entry for amalgamation in the books of the amalgamated company is recorded on the basis of the status of the shareholders of amalgamating company after amalgamation i.e. if all or almost all the shareholders of the amalgamated company has become shareholder of the amalgamating company by virtue of amalgamation, we record all the transactions as Amalgamation in nature of Merger otherwise it is recorded as Amalgamation in nature of Purchase.

Materiality: Financial statements should disclose all 'material' items, ie items the knowledge of which might influence the decisions of the user of the financial statements.

The materiality of an item is decided on the basis that whether non-disclosure of the item will effect the decision making of the user of accounts. If the answer is positive then the item is material and should be disclosed, in case answer is negative, item is immaterial. This statement does not mean that immaterial item should not be disclosed, disclosure or non-disclosure of an immaterial item is left at the discretion of the accountant but disclosure of material item is been made mandatory.

Example: Any penalty paid by the enterprise should be disclosed separately even though the amount paid is negligible, payment of any tax also should be disclosed separately and not to be merged with office expenses or miscellaneous expense.

2.7 Disclosure of Accounting Policies

(i) To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

(ii) The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

2.8 Disclosure of Changes in Accounting Policies

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 a later period 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.

2.9 Illustrations

Illustration 1

ABC Ltd. was making provision for non-moving inventorys 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:

Total value of inventory	*₹ 100 lakhs*
Provision required based on 12 months issue	*₹ 3.5 lakhs*
Provision required based on technical evaluation	*₹ 2.5 lakhs*

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 inventorys 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.

Reference: The students are advised to refer the full text of AS 1 "Disclosure of Accounting Policies."

Note: The ICAI has recently issued an Exposure Draft on Revised Accounting Standard 1 "Presentation of Financial Statements". AS 1 (revised) generally deals with presentation of financial statements, whereas the existing AS 1 (issued 1979) deals only with the disclosure of accounting policies. However, it is pertinent to note that this Exposure Draft has not yet been notified by the Govt. This Exposure Draft will come into effect only when it will be notified by the Govt.

UNIT 3 : AS 2 : VALUATION OF INVENTORIES

3.1 Introduction

The accounting treatment for inventories is prescribed in AS 2 'Valuation of Inventories', which provides guidance for determining the value at which inventories, are carried in the financial statements until related revenues are recognised. It also provides guidance on the cost formulas that are used to assign costs to inventories and any write-down thereof to net realisable value.

This Standard does not apply in accounting for the following inventories:

(a) Work in progress arising under construction contracts, including directly related service contracts.

(b) Work in progress arising in the ordinary course of business of service providers.

(c) Shares, debentures and other financial instruments held as inventory-in-trade and

(d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

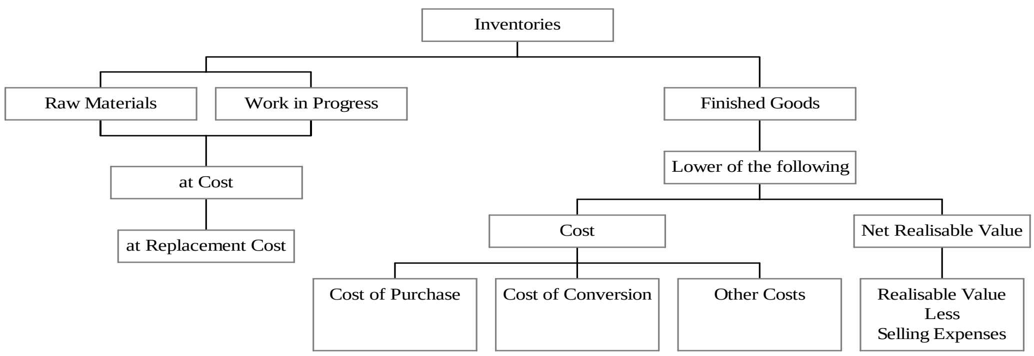
3.2 Scope

AS 2 defines inventories as assets-

(a) Held for sale in the ordinary course of business. It means finished goods ready for sale in case of a manufacturer and for traders, goods purchased by them with the intention of resale but not yet sold. These are known as Finished Goods.

(b) In the process of production for such sale. These refer to the goods which are introduced to the production process but the production is not yet completed i.e. not fully converted into finished goods. These are known as Work-in-Progress.

(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services. It refers to all the materials and spares i.e. to be consumed in the process of production. These are known as Raw Materials.



3.3 Measurement of Inventories

Inventories should be valued at the lower of cost and net realisable value.

3.3.1 Cost of Inventories

Cost of goods is the summation of:

(a) Cost of Purchase.

(b) Cost of Conversion.

(c) Other cost necessary to bring the inventory in present location and condition.

As shown in the above diagram, finished goods should be valued at cost or market price whichever is lower, in other words, finished goods are valued at the lower of cost or net realisable value.

Cost has three elements as discussed below:

Cost of Purchase Cost of purchase includes the purchase price plus all other necessary expenses directly attributable to purchase of inventory like, taxes and duties (other than those subsequently recoverable by the enterprise from the taxing authorities), carriage inward, loading/unloading excluding expenses recoverable from the supplier.

From the above sum, following items are deducted, duty drawback, CENVAT, VAT, trade discount, rebates.

Cost of Conversion For a trading company cost of purchase along with other cost (discussed below) constitutes cost of inventory, but for a manufacturer cost of inventory also includes cost of conversion. Readers can recollect the calculation of factory cost calculated in Cost Accounting:

Direct Material + Direct Labour = Prime Cost

Prime Cost + Factory Variable Overhead + Factory Fixed Overhead = Factory Cost.

Direct material is included in cost of purchase and the remaining items i.e. direct labour and overheads are termed as cost of conversion.

Direct labour is cost of workers in the unit who are directly associated with the production process, in other words we can say that direct labour is the cost of labour which can be directly attributed to the units of production.

Overheads are indirect expenses. Variable overheads are indirect expenses which is directly related to production i.e., it changes with the change in production in the same proportion (increase or decrease). Fixed overheads generally remains constant, it varies only when there is some major shift in production.

Since, direct labour and variable overheads are directly related with the production level, it is advisable to include them in cost of conversion on the basis of normal capacity. Because any difference between normal capacity and actual production will also bring in proportionate change in projected cost and actual cost.

For example: A unit is expected to produce 1 lacs units in a year with the projected labour cost ₹ 20 lacs and variable overhead ₹ 10 lacs. But the actual cost was only ₹ 18 lacs labour *charges and ₹ 9 lacs overheads with production only 90,000 units. Now if we take these costs on normal capacity basis then direct labour is ₹ 20 per unit (20 lacs/1 lac) and variable overhead is ₹ 10 per unit (10 lacs/1 lac). Therefore, in cost of conversion we include direct labour (90,000 x 20) ₹ 18 lacs and variable overheads (90,000 x 10) ₹ 9 lacs.*

Fixed overheads per unit are taken on the basis of normal capacity when actual production is equal to normal capacity or the difference is minor. In case when actual production increases normal capacity considerably, actual fixed overheads are included, however, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. When actual production is substancially less than normal capacity, fixed overhead per unit is included on the basis of normal capacity i.e. the amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred.

To understand the reason for such a provision we take an example

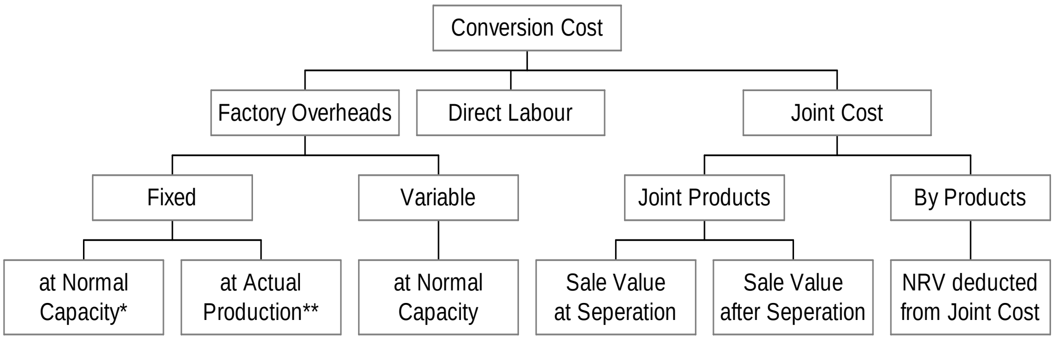
ABC Ltd. has a plant with the capacity to produce 1 lac unit of a product per annum and the expected fixed overhead is ₹ 18 lacs. Fixed overhead on the basis of normal capacity is ₹ 18 (18 lacs/1 lac).

Case 1: Actual production is 1 lac units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of ₹ 18 lacs. Therefore it is advisable to include this on normal capacity.

Case 2: Actual production is 90,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 20 (18 lacs/ 90 thousands). Hence by valuing inventory at ₹ 20 each for fixed overhead purpose, it will be overvalued and the losses of ₹ 1.8 lacs will also be included in closing inventory leading to a higher gross profit then actually earned. Therefore, it is advisable to include fixed overhead per unit on normal capacity to actual production (90,000 x 18) ₹ 16.2 lacs and rest ₹ 1.2 lacs shall be transferred to Profit & Loss Account.

Case 3: Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 15 (18 lacs/ 1.2 lacs). Hence by valuing inventory at ₹ 18 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 18 per unit, total fixed overhead comes to ₹ 21.6 lacs whereas, actual fixed overhead expense is only ₹ 18 lacs. Therefore, it is advisable to include fixed overhead on actual basis (1.2 lacs x 15) ₹ 18 lacs.

Sometimes, a single production process may result in more than one product. In case, this additional product is the intended item and has a good market value, they are known as joint products. The cost of conversion incurred on all the production and not identifiable separately is allocated among the products on some rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. If this additional product doesn't have good market value then they are considered as by-products. In this case, the net realisable value of the by-product is deducted from the total cost of conversion to calculate the cost of conversion for main product.



* When actual production is almost equal or lower than normal capacity.

** When actual production is higher than normal capacity.

Other Costs Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

Exclusion from the Cost of Inventories

AS 2 gives the following as examples of costs that should be excluded from the cost of inventories and recognised as expenses in the period in which they are incurred:

(a) Abnormal amounts of wasted materials, labour, or other production costs.

(b) Storage costs, unless those costs are necessary in the production process prior to a further production stage.

(c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition and

(d) Selling and distribution costs.

Borrowing Costs

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.

There may, however, be few exceptions to the above rule. As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset. Accordingly, inventories that necessarily take a substantial period of time to bring them to a saleable condition are qualifying assets.

As per AS 16, for inventories that are qualifying assets, any directly attributable borrowing costs should be capitalised as part of their cost.

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:

Direct Labour	*₹ 10,00,000*
Direct Variable Overheads	*₹ 1,00,000*
Direct Fixed Overheads	*₹ 1,00,000*
(Including interest ₹ 40,625)	

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

Particulars	₹
Cost of Purchase (1,00,000 x 100)	1,00,00,000
Direct Labour	10,00,000
Variable Overhead	1,00,000
Fixed Overhead $\frac{(1,00,000 - 40,625) \times 85,000}{95,000}$	53,125
Cost of Production	1,11,53,125
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:

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

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		(6,000)
Net realizable value of by-product BP		30,000

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		40,000
		3,40,000
Less: NRV of by-product BP (See calculation 1)	(30,000)	
Sale value of scrap	(6,000)	(36,000)
Joint cost to be allocated between MP1 and MP2		3,04,000

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

3.4 Cost Formulas

Following are the various cost formulae suggested by the statement:

Specific Identification Method It is suitable for the inventories where each unit of inventory along with their associated cost can be separately identified. In other words, it is suitable where one unit of inventory is not interchangeable with another unit. Under this method each unit is valued specifically on its original cost. Examples for such goods are ship building, machinery building.

The specific identification method is not appropriate for the routine production of inventories that are ordinarily interchangeable, since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

For items which are interchangeable, most appropriate method of cost valuation is either of the following two:

FIFO (First In First Out) It is assumed under this method that whatever is received first is issued first, which means, the inventory left over belongs to the latest purchases. Closing inventory is valued at the rates for the equivalent units purchased at last. During inflation inventory is valued at higher price and during decrease in price, inventory is valued at lower price.

Weighted Average Cost Under this method of inventory valuation, to determine the cost per unit, total cost of production during the year is divided by total units. In other words, for price per unit of the closing inventory we take the average price of the total goods purchased or produced during the year.

Following are cost formulae or techniques of measurement of cost suggested by the Accounting Standard for some special cases:

Standard Cost Method Inventories are valued on the basis of the set standards, which are realistic and reviewed regularly and where necessary, revised in the light of the current conditions. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation.

Retail Method It is recommended for retail business or in the business where the inventory comprises of many items, the individual costs of which are not readily ascertainable. All the inventories are valued at the selling price, which is then adjusted with normal gross profit ratio and selling expenses to reach at its cost.

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	10,000
	4,10,000
Less: Net Sales (₹ 4,50,000 – ₹ 11,250)	(4,38,750)
	(28,750)
Add: Gross Profits (₹ 4,38,750 x 20%)	87,750
Closing Inventory	59,000

3.5 Net Realisable Value (NRV)

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

When we say that inventory should be valued at the lower of cost or net realisable value, one should note that only under two circumstances cost of inventories will surpass its net realisable value:

1. The goods are damaged or obsolete and not expected to realise the normal sale price.
2. The cost necessary for the production of goods has gone up by greater degree.

Both the above cases we don't expect in the normal functioning of the business, hence whenever it is found that goods are valued at NRV, care should be taken to study the existing market position for the relevant products.

NRV of the goods are estimated on item to item basis and only items of the same characteristics are grouped together. Such estimation is made at the time of finalisation of accounts and circumstances existing on the date of balance sheet evident from the events after the balance sheet confirming the estimation should be taken into consideration. And assessment is made on each balance sheet date of such estimation.

While estimating the NRV, the purpose of holding the inventory should also be taken into consideration. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

For example, concern has 10,000 units in inventory, of which 6,000 is to be delivered for ₹ 40 each as per a contract with one of the customer. Cost of inventory is ₹ 45 and NRV estimated to be ₹ 50. In this case 6,000 units will be valued @ ₹ 40 each and rest 4,000 units will be valued @ ₹ 45 each.

This provision of cost or NRV whichever is less, is applicable to only those goods which are ready for sale i.e. finished goods. Since raw materials and work in progress are not available for sale, they don't have any realisable value and therefore NRV can never be estimated. For these goods statement suggests that these should always be valued at cost. Only exception is the case when the net realisable value of the relevant finished goods is lower than cost, in this case, the relevant raw materials and work in progress should be 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.

Illustration 4

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

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

Cost of Production	2,29,500
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)	₹ 8,550
	₹ 32,550

3.6 Disclosure

The financial statements should disclose:

(a) The accounting policies adopted in measuring inventories, including the cost formula used; and

(b) The total carrying amount of inventories together with a classification appropriate to the enterprise.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are

(1) raw materials and components,

(2) work in progress,

(3) finished goods,

(4) stores and spares, and

(5) loose tools.

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]	28,500	3,500
Value of Closing Inventory		2,81,200

3.7 Illustrations

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

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:

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 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.

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

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

Reference: The students are advised to refer the full text of AS 2 "Valuation of Inventories" (revised 1999).

UNIT 4 : AS 3 : CASH FLOW STATEMENTS

4.1 Introduction

This statement comes into effect in respect of accounting periods commencing on or after 1.4.1997. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June 1981. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1.4.2004 for the enterprises, which fall in the category of level I, at the end of the relevant accounting period. For all other enterprises though it is not compulsory but it is encouraged to prepare such statements. Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not supposed to disclose the figures for the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

4.2 Objective

Cash flow Statement (CFS) is an additional information provided to the users of accounts in the form of an statement, which reflects the various sources from where cash was generated (inflow of cash) by an enterprise during the relevant accounting year and how these inflows were utilised (outflow of cash) by the enterprise. This helps the users of accounts:

- To identify the historical changes in the flow of cash & cash equivalents.
- To determine the future requirement of cash & cash equivalents.
- To assess the ability to generate cash & cash equivalents.
- To estimate the further requirement of generating cash & cash equivalents.
- To compare the operational efficiency of different enterprises.
- To study the insolvency and liquidity position of an enterprise.
- As an indicator of amount, timing and certainty of future cash flows.
- To check the accuracy of past assessments of future cash flows
- In examining the relationship between profitability and net cash flow and the impact of changing prices.

Cash comprises cash on hand and demand deposits with banks.

Cash equivalents are short term (maximum three months of maturity from the date of acquisition), highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Example: Share Capital is not considered as cash equivalent even though they are readily convertible into cash because, the amount that will be realized on sale of investment is not determinable unless investment is actually sold. Similarly, fixed deposit for one year is also not considered as cash equivalent because they are not readily convertible into cash, even though the amount is determinable.

One should not be confused with the concept of three months or less. As this standard state very clearly that three months or less from the date of acquisition, any investment which is not classified as cash equivalent cannot be reclassified as cash equivalent, even when the maturity period is less than three months. We should look at the status only on the date of acquisition and not later.

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

4.3 Presentation of a Cash Flow Statement

AS 3 'Cash Flow Statements' requires the presentation of information about the historical changes in the cash and cash equivalents of an enterprise in the relevant accounting year by means of a cash flow statement, which classifies cash flows during the period according to operating, investing and financing activities.

4.3.1 Operating Activities

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

Examples of cash flows from operating activities are:

- cash received in the year from customers (in respect of sale of goods or services rendered either in the year, or in an earlier year, or received in advance in respect of the sale of goods or services to be rendered in a later year);
- cash payments in the year to suppliers (for raw materials or goods for resale whether supplied in the current year, or an earlier year, or to be supplied in a later year);
- the payment of wages and salaries to employees;
- tax and other payments on behalf of employees;
- the payment of rent on property used in the business operations; royalties received in the year;
- cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- the payment of insurance premiums;
- cash payments or refunds of income taxes that cannot be specifically identified with financing or investing activities
- cash flows arising from futures contracts, forward contracts, option contracts or swap contracts hedging a transaction that is itself classified as operating; and
- cash flows arising from the purchase and sale of securities and loans held for dealing or trading purposes.

4.3.2 Investing Activities

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

Examples of cash flows arising from investing activities include:

- cash payment to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;
- cash receipts from disposal of fixed assets (including intangibles);
- cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
- cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
- cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading purposes or the receipts are classified as financing activities.

4.3.3 Financing Activities

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

Examples of cash flows arising from financing activities are:

- cash proceeds from issuing shares or other similar instruments;
- cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
- cash repayments of amounts borrowed.

So all the transactions should be classified under each of these heads and presented in CFS, this kind of presentation gives a very clear idea to the users regarding the major sources of cash inflows, from where all the activities are financed by the enterprises. Say if net cash flow from operating activities is negative and net cash flow from investing activities is positive, this does not potrait a good picture of the functioning of the enterprise. Sometimes, a single transaction may include cash flows that are classified differently. For example, a fixed asset acquired out of loan taken from bank on deferred payment basis includes the loan element which will be classified under financing activities and the asset acquired will be classified under investing activities.

As discussed earlier, operating activities are those activities which determine the profit/loss result of the enterprise, hence this head helps us to determine that whether the concern has sufficient cash inflow from their normal operations to support their operating cash outflow, and also the other cash outflow.

There are few extraordinary items, which are recorded in Profit and Loss Account, but are not to be classified as operating activity, such as, profit/loss on sale of fixed asset. Fixed assets are to be classified as investing activities, therefore any sale proceeds from such items will go to investing activities. If investments are held as inventory in trade, in such a case we will disclose them as operating activities.

Illustration 1

Classify the following activities as (a) Operating Activities, (b) Investing Activities, (c) Financing Activities (d) Cash Equivalents.

a. *Purchase of Machinery.*

b. *Proceeds from issuance of equity share capital*

c. *Cash Sales.*

d. *Proceeds from long-term borrowings.*

e. *Proceeds from Trade receivables.*

f. *Cash receipts from Trade receivables.*

g. *Trading Commission received.*

h. *Purchase of investment.*

i. *Redemption of Preference Shares.*

j. *Cash Purchases.*

k. *Proceeds from sale of investment*

l. *Purchase of goodwill.*

m. *Cash paid to suppliers.*

n. *Interim Dividend paid on equity shares.*

o. *Wages and salaries paid.*

p. *Proceed from sale of patents.*

q. *Interest received on debentures held as investment.*

r. *Interest paid on Long-term borrowings.*

s. *Office and Administration Expenses paid* *t.* *Manufacturing Overheads paid.*

u. *Dividend received on shares held as investments.*

v. *Rent Received on property held as investment.*

w. *Selling and distribution expense paid.*

x. *Income tax paid*

y. *Dividend paid on Preference shares.*

z. *Underwritings Commission paid.*

aa. *Rent paid.*

bb. *Brokerage paid on purchase of investments.*

cc. *Bank Overdraft*

dd. *Cash Credit*

ee. *Short-term Deposits*

ff. *Marketable Securities*

gg. *Refund of Income Tax received.*

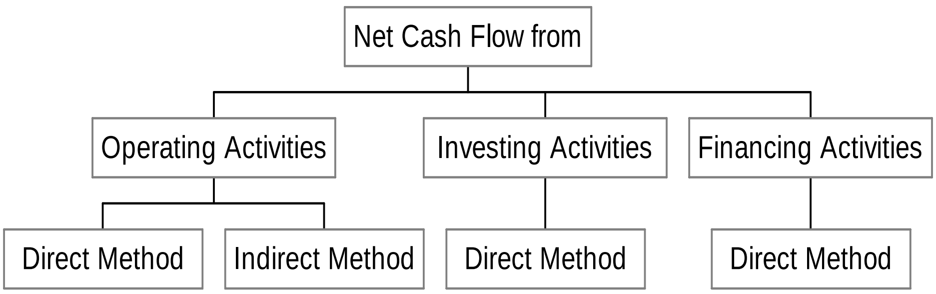
Solution

Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

Investing Activities: a, h, k, l, p, q, u, v, bb & ee.

Financing Activities: b, d, i, n, r, y, z, cc & dd.

Cash Flow during the Year is



Cash Equivalent: ff.

4.4 Reporting Cash Flow from Operating Activities

Net cash flow from operating activities can be reported either as direct method or as indirect method.

In 'Direct method' we take the gross receipts from sales, trade receivables and other operating inflows subtracted by gross payments for purchases, creditors and other expenses ignoring all non-cash items like depreciation, provisions. In 'Indirect method' we start from the net profit or loss figure, eliminate the effect of any non cash items, investing items and financing items from such profit figure i.e. all such expenses like depreciation, provisions, interest paid, loss on sale of assets etc. are added and interest received etc. are deducted. Adjustment for changes in working capital items are also made ignoring cash and cash equivalent to reach to the figure of net cash flow.

Direct method is preferred over indirect because, direct method gives us the clear picture of various sources of cash inflows and outflows which helps in estimating the future cash inflows and outflows.

Below is the format for Cash Flow Statement

Cash Flow Statement of X Ltd. for the year ended March 31, 20XX (Direct Method)

Particulars	₹	₹
Operating Activities:		
Cash received from sale of goods	xxx	
Cash received from Trade receivables	xxx	
Cash received from sale of services	xxx	xxx
Less: Payment for Cash Purchases	xxx	
Payment to Trade payables	xxx	
Payment for Operating Expenses	xxx	
e.g. power, rent, electricity		
Payment for wages & salaries	xxx	
Payment for Income Tax	xxx	xxx
		xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Indirect Method)

Particulars	₹	₹
Operating Activities:		
Closing balance of Profit & Loss Account	xxx	
Less: Opening balance of Profit & Loss Account	xxx	
	xxx	
Reversal of the effects of Profit & Loss Appropriation Account	xxx	

Add: Provision for Income Tax	xxx	
Effects of Extraordinary Items	xxx	
Net Profit Before Tax and Extraordinary Items	xxx	
Reversal of the effects of non-cash and non-operating items	xxx	
Effects for changes in Working Capital except cash & cash equivalent	xxx	
	xxx	
Less : Payment of Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Illustration 2

From the following information, calculate cash flow from operating activities:

Summary of Cash Account
for the year ended March 31, 2013

Particulars	*₹*	*Particulars*	*₹*
To Balance b/d	*1,00,000*	*By Cash Purchases*	*1,20,000*
To Cash sales	*1,40,000*	*By Trade payables*	*1,57,000*
To Trade receivables	*1,75,000*	*By Office & Selling Expenses*	*75,000*
To Trade Commission	*50,000*	*By Income Tax*	*30,000*
To Sale of Investment	*30,000*	*By Investment*	*25,000*
To Loan from Bank	*1,00,000*	*By Repay of Loan*	*75,000*
To Interest & Dividend	*1,000*	*By Interest on loan*	*10,000*
		By Balance c/d	*1,04,000*
	5,96,000		*5,96,000*

Solution

Cash Flow Statement of ……
for the year ended March 31, 2013 (Direct Method)

Particulars	₹	₹
Operating Activities:		
Cash received from sale of goods	1,40,000	
Cash received from Trade receivables	1,75,000	
Trade Commission received	50,000	3,65,000
Less: Payment for Cash Purchases	1,20,000	

Payment to Trade payables	1,57,000	
Office and Selling Expenses	75,000	
Payment for Income Tax	30,000	(3,82,000)
Net Cash used in Operating Activities		(17,000)

Illustration 3

Ms. Jyoti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year ended 31st March, 2013:

	(₹ in lakhs)
Net Profit	*25,000*
Dividend (including dividend tax) paid	*8,535*
Provision for Income tax	*5,000*
Income tax paid during the year	*4,248*
Loss on sale of assets (net)	*40*
Book value of the assets sold	*185*
Depreciation charged to Profit & Loss Account	*20,000*
Amortisation of Capital grant	*6*
Profit on sale of Investments	*100*
Carrying amount of Investment sold	*27,765*
Interest income received on investments	*2,506*
Interest expenses	*10,000*
Interest paid during the year	*10,520*
Increase in Working Capital (excluding Cash & Bank Balance)	*56,075*
Purchase of fixed assets	*14,560*
Investment in joint venture	*3,850*
Expenditure on construction work in progress	*34,740*
Proceeds from calls in arrear	*2*
Receipt of grant for capital projects	*12*
Proceeds from long-term borrowings	*25,980*
Proceeds from short-term borrowings	*20,575*
Opening cash and Bank balance	*5,003*
Closing cash and Bank balance	*6,988*

Prepare the Cash Flow Statement for the year ended 31st March, 2013, in accordance with AS 3 'Cash Flow Statements' issued by the Institute of Chartered Accountants of India.

Solution

Star Oils Limited
Cash Flow Statement
for the year ended 31st March, 2013

	(₹ in lakhs)
Cash flows from operating activities	
Net profit before taxation (25,000 + 5,000)	30,000
Adjustments for :	
Depreciation	20,000
Loss on sale of assets (Net)	40
Amortisation of capital grant	(6)
Profit on sale of investments	(100)
Interest income on investments	(2,506)
Interest expenses	10,000
Operating profit before working capital changes	57,428
Changes in working capital (Excluding cash and bank balance)	(56,075)
Cash generated from operations	1,353
Income taxes paid	(4,248)
Net cash used in operating activities	(2,895)
Cash flows from investing activities	
Sale of assets (185 – 40)	145
Sale of investments (27,765 + 100)	27,865
Interest income on investments	2,506
Purchase of fixed assets	(14,560)
Investment in joint venture	(3,850)
Expenditure on construction work-in progress	(34,740)
Net cash used in investing activities	(22,634)
Cash flows from financing activities	
Proceeds from calls in arrear	2
Receipts of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceed from short-term borrowings	20,575

Interest paid	(10,520)
Dividend (including dividend tax) paid	(8,535)
	27,514
Net increase in cash and cash equivalents (27,514 – 22,634 – 2,895)	1,985
Cash and cash equivalents at the beginning of the period	5,003
Cash and cash equivalents at the end of the period	6,988

Illustration 4

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2012 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.

Summary Cash Account for the year ended 31.3.2012

	₹'000		*₹'000*
Balance on 1.4.2011	*50*	*Payment to Suppliers*	*2,000*
Issue of Equity Shares	*300*	*Purchase of Fixed Assets*	*200*
Receipts from Customers	*2,800*	*Overhead expense*	*200*
Sale of Fixed Assets	*100*	*Wages and Salaries*	*100*
		Taxation	*250*
		Dividend	*50*
		Repayment of Bank Loan	*300*
		Balance on 31.3.2012	*150*
	3,250		*3,250*

Solution

X Ltd.

Cash Flow Statement for the year ended 31st March, 2012

(Using the direct method)

	₹'000	*₹000*
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250
Cash flows from investing activities		
Payments for purchase of fixed assets	(200)	

Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		100
Cash at beginning of the period		50
Cash at end of the period		150

Illustration 5

The summarised Balance Sheet of New Light Ltd. for the years ended 31st March, 2011 and 2012 are as follows:

Liabilities	31st March 2011 (₹)	31st March 2012 (₹)	Assets	31st March 2011 (₹)	31st March 2012 (₹)
Equity share capital	11,20,000	15,60,000	Fixed Assets	32,00,000	38,00,000
10% Preference share capital	4,00,000	2,80,000	Less: Depreciation	9,20,000	11,60,000
				22,80,000	26,40,000
Capital Reserve	–	40,000	Investment	4,00,000	3,20,000
General Reserve	6,80,000	8,00,000	Cash	10,000	10,000
Profit and Loss A/c	2,40,000	3,00,000	Other current assets	11,10,000	13,10,000
9% Debentures	4,00,000	2,80,000			
Current liabilities	4,80,000	5,36,000			
Proposed dividend	1,20,000	1,44,000			
Provision for Tax	3,60,000	3,40,000			
	38,00,000	42,80,000		38,00,000	42,80,000

Additional information:

(i) The company sold one fixed asset for ₹ 1,00,000, the cost of which was ₹ 2,00,000 and the depreciation provided on it was ₹ 80,000.

(ii) The company also decided to write off another fixed asset costing ₹ 56,000 on which depreciation amounting to ₹ 40,000 has been provided.

(iii) Depreciation on fixed assets provided ₹ 3,60,000.

(iv) Company sold some investment at a profit of ₹ 40,000, which was credited to capital reserve.

(v) Debentures and preference share capital redeemed at 5% premium.

(vi) Company decided to value inventory at cost, whereas previously the practice was to value inventory at cost less 10%. The inventory according to books on 31.3.2011 was ₹ 2,16,000. The inventory on 31.3.2012 was correctly valued at ₹ 3,00,000.

Prepare Cash Flow Statement as per revised AS 3 by indirect method.

Solution

New Light Ltd.
Cash Flow Statement for the year ended 31st March, 2012

		₹	₹
A.	Cash Flow from operating activities		
	Profit after appropriation		
	Increase in profit and loss A/c after inventory adjustment [₹ 3,00,000 – (₹ 2,40,000 + ₹ 24,000)]	36,000	
	Transfer to general reserve	1,20,000	
	Proposed dividend	1,44,000	
	Provision for tax	3,40,000	
	Net profit before taxation and extraordinary item	6,40,000	
	Adjustments for:		
	Depreciation	3,60,000	
	Loss on sale of fixed assets	20,000	
	Decrease in value of fixed assets	16,000	
	Premium on redemption of preference share capital	6,000	
	Premium on redemption of debentures	6,000	
	Operating profit before working capital changes	10,48,000	
	Increase in current liabilities (₹ 5,36,000 –₹ 4,80,000)	56,000	
	Increase in other current assets [₹ 13,10,000 – (₹ 11,10,000 + ₹ 24,000)] (W.N.1)	(1,76,000)	
	Cash generated from operations	9,28,000	
	Income taxes paid	(3,60,000)	
	Net Cash from operating activities		5,68,000
B.	Cash Flow from investing activities		
	Purchase of fixed assets (W.N.3)	(8,56,000)	
	Proceeds from sale of fixed assets	1,00,000	

	Proceeds from sale of investments (W.N.2)	1,20,000	
	Net Cash from investing activities		(6,36,000)
C.	Cash Flow from financing activities		
	Proceeds from issuance of share capital	4,40,000	
	Redemption of preference share capital (₹1,20,000 + ₹ 6,000)	(1,26,000)	
	Redemption of debentures (₹ 1,20,000 + ₹ 6,000)	(1,26,000)	
	Dividend paid	(1,20,000)	
	Net Cash from financing activities		68,000
	Net increase/decrease in cash and cash equivalent during the year		Nil
	Cash and cash equivalent at the beginning of the year		10,000
	Cash and cash equivalent at the end of the year		10,000

Working Notes:

1. Revaluation of inventory will increase opening inventory by ₹ 24,000.

$$\frac{2,16,000}{90} \times 10 = ₹\ 24,000$$

Therefore, opening balance of other current assets would be as follows:

₹ 11,10,000 + ₹ 24,000 = ₹ 11,34,000

Due to under valuation of inventory, the opening balance of profit and loss account be increased by ₹ 24,000.

The opening balance of profit and loss account after revaluation of inventory will be

₹ 2,40,000 + ₹ 24,000 = ₹ 2,64,000.

2. Investment Account

		₹			₹
To	Balance b/d	4,00,000	By	Bank A/c (balancing figure being investment sold)	1,20,000
To	Capital reserve A/c (Profit on sale of investment)	40,000	By	Balance c/d	3,20,000
		4,40,000			4,40,000

3. Fixed Assets Account

		₹			₹	₹
To	Balance b/d	32,00,000	By	Bank A/c (sale of assets)	1,00,000	

To	Bank A/c (balancing figure being assets purchased)	8,56,000	By	Accumulated depreciation A/c	80,000	
			By	Profit and loss A/c (loss on sale of assets)	20,000	2,00,000
			By	Accumulated depreciation A/c	40,000	
			By	Profit and loss A/c (assets written off)	16,000	56,000
			By	Balance c/d		38,00,000
		40,56,000				40,56,000

4. Accumulated Depreciation Account

		₹			₹
To	Fixed assets A/c	80,000	By	Balance b/d	9,20,000
To	Fixed assets A/c	40,000	By	Profit and loss A/c	
To	Balance c/d	11,60,000		(depreciation for the period)	3,60,000
		12,80,000			12,80,000

4.5 Reporting Cash Flows on Net Basis

Paragraph 21 forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets.

Example: If an enterprise pays ₹ 50,000 in acquisition of machinery and realises ₹ 10,000 on disposal of furniture, it is not right to show net cash outflow of ₹ 40,000. The exceptions to this rule are stated in paragraphs 22 and 24.

As per paragraph 22, cash flows from the following operating, investing or financing activities may be reported on a net basis.

(a) Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.

(b) Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

Paragraph 24 permits financial enterprises to report cash flows on a net basis in the following three circumstances.

(a) Cash flows on acceptance and repayment of fixed deposits

(b) Cash flows on placement and withdrawal deposits from other financial enterprises

(c) Cash flows on advances/loans given to customers and repayments received there from.

Non-Cash transactions (Paragraph 40)

Investing and financing transactions that do not require the use of cash or cash equivalents, e.g. issue of bonus shares, should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Business Purchase

The aggregate cash flows arising from acquisitions and disposals of business units should be presented separately and classified as cash flow from investing activities. (Paragraph 37)

(a) The cash flows from disposal and acquisition should not be netted off. (Paragraph 39)

(b) As per paragraph 38, an enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

 (i) The total purchase or disposal consideration; and

 (ii) The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

Treatment of current assets and liabilities taken over on business purchase

Business purchase is not operating activity. Thus, while taking the differences between closing and opening current assets and liabilities for computation of operating cash flows, the closing balances should be reduced by the values of current assets and liabilities taken over. This ensures that the differences reflect the increases/decreases in current assets and liabilities due to operating activities only.

4.6 Foreign Currency Cash Flows and Exchange Gains and Losses

The foreign currency monetary assets (e.g. balance with bank, trade receivables etc.) and liabilities (e.g. trade payables) are initially recognised by translating them into reporting currency by the rate of exchange transaction date. On the balance sheet date, these are restated using the rate of exchange on the balance sheet date. The difference in values is exchange gain/loss. The exchange gains and losses are recognised in the statement of profit and loss (See AS 11 for details).

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance sheet date. The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated excusive of exchange gains and losses.

The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement. (Paragraph 25)

4.7 Disclosures

Paragraph 45 requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

Paragraph 47 encourages disclosure of additional information, relevant for understanding the financial position and liquidity of the enterprise. Such information may include:

(a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and

(b) The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

Reference: The students are advised to refer the full text of AS 3 “Cash Flow Statements” (revised 1997).

UNIT 5 : AS 4: CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

5.1 Introduction

Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other Indian AS. The project of revision of this standard by ASB in the light of newly issued AS 29 is under progress. Thus, the present standard (AS 4) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet. Events occurring after the balance sheet date are those significant events (favourable as well unfavourable) that occur between the balance sheet date and the date on which financial statements are approved by the approving authority (i.e. board of directors in case of a company) of any entity.

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature.

5.2 Contingencies

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events. *(Refer to unit 29 for discussion on AS 29)*

5.3 Events Occurring after the Balance Sheet Date

Events occurring after the balance sheet date are 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 Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

For example, for the year ending on 31st March 2012, financial statement is finalized and approved by the company in its AGM held on 04th September 2012. In this case the events taking place between 01st April 2012 to 04th September 2012 are termed as events occurring after the balance sheet date.

Two types of events can be identified

a. those which provide further evidence of conditions that existed at the balance sheet date. For example a trade receivable declared insolvent and estate unable to pay full amount against whom provision for doubtful debt was created.

b. those which are indicative of conditions that arose subsequent to the balance sheet date. An event which ceases the enterprise from being going concern.

Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

Assets and liabilities should be adjusted for events occurring after the balance sheet date that indicate that the fundamental accounting assumption of going concern (ie existence or substratum of the enterprise) is not appropriate.

5.4 Disclosure

Disclosure of events occurring after the balance sheet date requires the following information should be provided:

(a) The nature of the event;

(b) An estimate of the financial effect, or a statement that such an estimate cannot be made.

5.5 Illustrations

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.

Reference: The students are advised to refer the full text of AS 4 "Contingencies* and Events occurring after the Balance Sheet Date" (revised 1995).

Note: *It should be noted that to the ICAI has recently issued an Exposure Draft on Limited revision to Accounting Standard 4 "Events Occurring after the Balance Sheet Date" to harmonize the requirements of AS 4 with the requirements of the revised Schedule VI to the Companies Act, 1956 (now as Schedule III to the companies Act, 2013) . However, it is pertinent to note that this Limited Revision has not yet been notified by the Government. This Limited Revision will come into effect as and when it will be notified by the Government.*

* Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other Indian AS.

UNIT 6 : AS 5: NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

6.1 Introduction

This revised standard AS 5 comes into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature.

The objective of AS 5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

6.2 Net Profit or Loss for the Period

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

(a) **Profit or loss from ordinary activities:** Any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities. For example profit on sale of merchandise, loss on sale of unsold inventory at the end of the season.

(b) **Extraordinary items:** Income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. For example, profit on sale of furniture or heavy loss of goods due to fire.

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

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 rise to the separate disclosure of items of income and expense include:

(a) The write-down of inventories to net realisable value as well as the reversal of such write-downs.

(b) A restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring.

(c) Disposals of items of fixed assets.

(d) Disposals of long-term investments.

(e) Legislative changes having retrospective application.

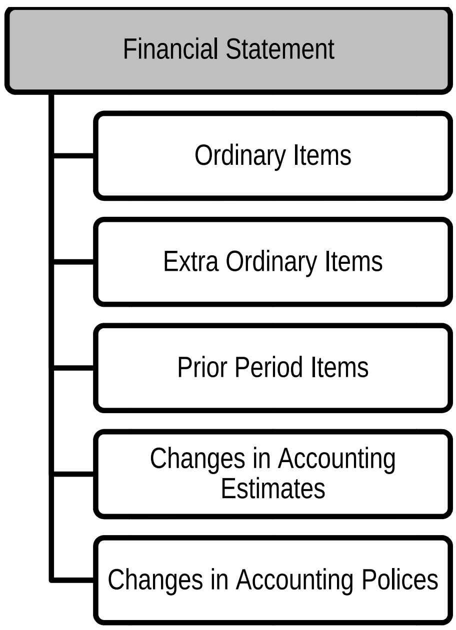
(f) Litigation settlements.

(g) Other reversals of provisions.

6.3 Prior Period Items

Prior period items are income or expenses which arise in the current period as a result of

Disclosure under Following Category



errors or omissions in the preparation of the financial statements of one or more prior periods. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates.

Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

For example, Mr. Sachin purchased a new machine costing ₹ 10 lacs. Useful life was taken to be for 10 years therefore depreciation was charged at 10% on original cost each year. After 5 years when carrying amount was ₹ 5 lacs for the machine, management realizes that machine can work for another 2 years only and they decide to write off ₹ 2.5 lacs each year. This is not an example of prior period item but change in accounting estimate. In the same example management by mistake calculates the depreciation in the fifth year as 10% of ₹ 6,00,000 i.e. ₹ 60,000 instead of ₹ 1,00,000 and in the next year decides to write off ₹ 1,40,000. ₹ 1,00,000 current year's depreciation and ₹ 40,000 as prior period item.

6.4 Changes in Accounting Estimates

An estimate may have to be revised if changes occur in the circumstances based on which the estimate was made, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

(a) The period of the change, if the change affects the period only; or

(b) The period of the change and future periods, if the change affects both.

To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

6.5 Changes in Accounting Policies

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

The following are not changes in accounting policies:

(a) The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement;

(b) The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Accounting Policies can be changed only:

- when the adoption of a different accounting policy is required by statute; or
- for compliance with an Accounting Standard; or
- when it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

6.6 Miscellaneous Illustrations

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 are 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 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.

Reference: The students are advised to refer the full text of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" (revised 1997).

Note: The ICAI has recently issued an Exposure Draft on Revised Accounting Standard 5 "Accounting Policies, Changes in Accounting Estimates and Errors". However, it is pertinent to note that this Limited Revision has not yet been notified by the Government. This Limited Revision will come into effect as and when it will be notified by the Government.

UNIT 7 : AS 6 : DEPRECIATION ACCOUNTING

7.1 Introduction

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature.

This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply: -

(i) Forests, plantations and similar regenerative natural resources;

(ii) Wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

(iii) Expenditure on research and development;

(iv) Goodwill;

(v) Live stock:- Cattle, Animal Husbandry

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

7.2 Depreciation

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

7.3 Depreciable Assets

Depreciable assets are assets which

(i) Are expected to be used during more than one accounting period. Dies and blocks are written off on first year itself as their useful life ends within one year.

(ii) Have a limited useful life. Depreciation is not charged on land as the useful of land cannot be determined, it is endless.

(iii) Are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business. Depreciation is not charged on assets purchased for the purpose of resale but could not be sold till the end of the accounting year.

7.4 Depreciable Amount

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable Amount = Historical Cost – Residual Value.

Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(i) Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;

(ii) Expected useful life of the depreciable asset; and

(iii) Estimated residual value of the depreciable asset.

7.5 Historical Cost

Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof.

For example, Mr. Rahul imported machine from Germany on the condition that machine will be run on trail basis for 15 days, if machine works perfectly it will be purchased or else it will be rejected. Now since trial run is the necessary condition for acquisition of the machinery, the cost incurred for trail run net of any revenue generated will be capitalized i.e. added to the historical cost of the machine.

The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

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	(10)
	490
Less: Subsidy (490 x 25%)	(122.50)
Depreciable Value	367.50

7.6 Useful Life

Useful life of a depreciable asset is shorter than its physical life. Useful life depends upon the following factors

(i) Pre-determined by legal or contractual limits

Example- Asset given on lease, the estimated life is period of lease.

(ii) Depends upon the number of shifts for which the asset is to be used.

(iii) Repair and Maintenance policy of enterprise.

(iv) Technological obsolescence

(v) Innovation/ improvements in the production method.

(vi) Change in demand of output.

(vii) Legal or other restrictions.

Useful life is either

(i) The period over which a depreciable asset is expected to be used by the enterprise; or

(ii) The number of production or similar units expected to be obtained from the use of the asset by the enterprise.

7.7 Additions to Existing Assets

Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

For example, the engine of an aircraft is replace, in this case since the life of engine is not depended on the life of the aircraft body, depreciation charged on both is recorded separately.

7.8 Amount of Depreciation

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

7.9 Methods of Depreciation

There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s) A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired, e.g. books.

(a) *Straight Line Method:* An equal amount is written off every year during the working life on an asset so as to reduce the cost of the asset to NIL or to its residual value at the end of its useful life.

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset - Scrap Value}}{\text{Useful Life}}$$

$$\text{Depreciation Rate} = \frac{\text{Straight Line Depreciation} \times 100}{\text{Cost of Asset}}$$

This method of charging depreciation is recommended mostly for power generating units or for the assets where danger of obselence is low.

(b) *Reducing Balance/Written Down Value Method:* A fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its salvage value at the end of its life.

$$\text{Depreciation Rate} = \frac{1}{n}\left[\frac{\text{Re sidual Value}}{\text{Cost of Asset}} \times 100\right]$$

n = useful life.

This method is highly recommended mainly for manufacturing units though it is recommended for most of the enterprises.

Distinction between Straight Line and Written Down Value Method:

	Straight Line Method	Written Down Value
1.	Amount of depreciation is calculated at a fixed percentage on the original cost of the fixed asset.	Amount of depreciation is calculated at a fixed percentage on written down value of the fixed amount.
2.	Amount of depreciation remains same year to year.	Amount of depreciation decreases year to year.
3.	At the end of the life, the value of asset can be zero.	The value of assets never comes to zero.
4.	It is also known as Fixed Instalment Method or Constant Charge Method.	It is also known as Reducing or Diminishing Balance Method.
5.	It is easy to calculate.	It is difficult to calculate.
6.	Depreciation + Repair keeps increasing.	Depreciation + Repairs more or less remains constant.
7.	Suitable for the assets that requires fewer repairs.	Suitable for assets, which requires more repairs with passage of time.

(c) *Sum of the Year Digit Method (SYD):* Under this method, the rate of depreciation is charged on the original cost. However, the rate of depreciation for each year is a fraction in which the denominator is the sum of the year digits from 1 to n and numerator for the first year is n, for the second year n-1, for the third year n-2 and so on.

Rate of Depreciation for each year is = $\dfrac{n-(x-1)}{n(n+1)/2}$

Where, n = useful life of the asset.

x = number of years asset is in use.

(d) *Machine Hour Method:* Where it is practically possible to keep a record of the actual running hours of each machine, depreciation may be calculated on the basis of hours that the concerned machine worked.

$$\text{Depreciation for year 'n'} = \frac{\text{Hours worked in n x (Cost - Salvage Value)}}{\text{Total Estimated Working Hours}}$$

This method is recommended for the assets mainly machinery, where in the cost of the asset was determined mainly based on the useful working hours of the machine.

(e) *Depletion Method:* This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available.

$$\text{Depreciation for year 'n'} = \frac{\text{Qty. Extracted / Produced in 'n'} \times \text{(Cost - Residual Value)}}{\text{Total Estimated Quantity}}$$

(f) *Annuity Method:* This is a method of depreciation which also takes into account the element of interest on capital outlay and seeks to write off the value of the asset as well as the interest lost over the life of the asset. On that basis, the amount of depreciation to be annually provided in the account is ascertained from the Annuity Tables. Though the amount written off annually is constant, the interest in the earlier years being greater, only small amount of the capital outlay is written off. This proportion is reversed with the passage of time.

This method of charging depreciation is mostly recommended for leasehold assets.

(g) *Sinking Fund Method:* If the sum involved in replacing the asset is large, than just providing for depreciation will not be sufficient, as because the concern may not have the ready fund available to replace the assets. For this purpose a Sinking Fund Account is created, a depreciation amount is credited to it. The amount is invested in some Government Securities. Every year the process is repeated, the interest received from such securities are also reinvested and these securities are sold at the end of the life of the asset, so that the concern has the ready fund to replace the asset.

7.10 Basis for Computation of Depreciation

The statute governing an enterprise may provide the basis for computation of the depreciation. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

7.11 Disposal of Assets

Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

7.12 Change in Method of Depreciation

When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective re-computation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed and it is charged or credited to Profit & Loss Account as per the case.

Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

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
				By Balance c/d	2,30,000
		3,96,250			3,96,250
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
				By Balance c/d	1,67,195
		2,30,000			2,30,000
01.04.2012	To Balance b/d	1,67,195			

7.13 Disclosure

(1) The depreciation methods used,

(2) The total depreciation for the period for each class of assets,

(3) The gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies.

(4) The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.

(5) In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

Reference: The students are advised to refer the full text of AS 6 "Depreciation Accounting" (revised 1994)

UNIT 8 : AS 7: CONSTRUCTION CONTRACTS

8.1 Introduction

AS 7, comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature. This Statement should be applied in accounting for construction contracts in the financial statements of contractors. The standard prescribes the accounting treatment of revenue and costs associated with construction contracts by laying down the guidelines regarding allocation of contract revenue and contract costs to the accounting periods in which the construction work is performed, since the construction activity is generally contracted and completed in more than one accounting period.

8.2 Definitions of the terms used in the Standard

A **construction contract** is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A **fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A **cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

8.3 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:

(a) Separate proposals have been submitted for each asset;

(b) Each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) The costs and revenues of each asset can be separately identified.

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

(a) The group of construction contracts is negotiated as a single package;

(b) The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) The contracts are performed concurrently or in a continuous sequence.

A construction contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

(a) The asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) The price of the asset is negotiated without regard to the original contract price.

8.4 Contract Revenue

Contract revenue should comprise:

(a) The initial amount of revenue agreed in the construction contract; and

(b) Variations in contract work, claims and incentive payments:

  (i) To the extent that it is probable that they will result in revenue; and

  (ii) They are capable of being reliably measured.

Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) A contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) The amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) The amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) When a fixed price contract involves a fixed price per unit of output, contract revenue increases/ decreases as the number of units is increased/ decreased.

8.5 Contract Costs

Contract costs should comprise:

(a) Costs that relate directly to the specific contract;

  1. Site labour costs, including site supervision;
  2. Costs of materials used in construction;
  3. Depreciation of plant and equipment used on the contract;
  4. Costs of moving plant, equipment and materials to and from the contract site;
  5. Costs of hiring plant and equipment;
  6. Costs of design and technical assistance that aredirectly related to the contract;
  7. The estimated costs of rectification and guarantee work, including expected warranty costs; and
  8. Claims from third parties.

(b) Costs that are attributable to contract activity in general and can be allocated to the contract; and

1. Insurance;
2. Costs of design and technical assistance that are not directly related to a specific contract; and
3. Construction overheads.
4. Borrowing costs capitalized under AS 16 Borrowing cost

(c) Such other costs as are specifically chargeable to the customer under the terms of the contract.

Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) General administration costs for which reimbursement is not specified in the contract;

(b) Selling costs;

(c) Research and development costs for which reimbursement is not specified in the contract; and

(d) Depreciation of idle plant and equipment that is not used on a particular contract.

8.6 Recognition of Contract Revenue and Expenses

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately.

In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) Total contract revenue can be measured reliably;

(b) It is probable that the economic benefits associated with the contract will flow to the enterprise;

(c) Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

(d) The contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when both the following conditions are satisfied:

(a) It is probable that the economic benefits associated with the contract will flow to the enterprise; and

(b) The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

(a) The proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) Surveys of work performed; or

(c) Completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

When the outcome of a construction contract cannot be estimated reliably:

(a) Revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

(b) Contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately.

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate.

8.7 Disclosure

An enterprise should disclose:

(a) The amount of contract revenue recognised as revenue in the period;

(b) The methods used to determine the contract revenue recognised in the period; and

(c) The methods used to determine the stage of completion of contracts in progress.

An enterprise should disclose the following for contracts in progress at the reporting date:

(a) The aggregate amount of costs incurred and recognised profits (less recognised losses) to date

(b) The amount of advances received; and

(c) The amount of retentions.

Advances are recognized as liabilities until the related revenue is earned.

'Retentions' are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Retentions are recognized as receivables in the balance sheet of the contractor. An enterprise should present:

(a) The gross amount due from customers for contract work as an asset; and

(b) The gross amount due to customers for contract work as a liability.

8.8 Illustrations

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	(1,000)
	Total foreseeable loss to be recognized as expense	100

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	105
		605

This is 55% (605/1,100 × 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 31st March, 2012	64,99,000
	Prudent estimate of additional cost for completion	32,01,000
	Total cost of construction	97,00,000
	Less: Contract price	(85,00,000)
	Total foreseeable loss	12,00,000

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

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

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

= 67% of ₹ 85,00,000 = ₹ 56,95,000.

<u>Reference</u>: The students are advised to refer the full text of AS 7 “Construction Contracts” (revised 2002)

UNIT 9 : AS 9: REVENUE RECOGNITION

9.1 Introduction

This statement was issued by ICAI in the year 1985 and in the initial years it was recommendatory for only level I enterprises and but was made mandatory for enterprise from April 01, 1993.

9.2 Revenue

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts;

(ii) Revenue arising from hire-purchase, lease agreements;

(iii) Revenue arising from government grants and other similar subsidies;

(iv) Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of "revenue" for the purpose of this Statement are:

(i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

(ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

(iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

(iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

(v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

9.3 Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

9.4 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.

Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable

9.5 Interest, Royalties and Dividends

The use by others of such enterprise resources gives rise to:

(i) **Interest**: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable. For example, debenture interest payable on every June 30th and December 31st. On March 31st when books will be closed, though interest has not fallen due but still interest for the period January, February and March will be recognised on time basis.

(ii) **Royalties:** charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement. If agreement is signed for royalty payable on the basis of the number of copies of the book published, it will be recognised on that basis only.

(iii) **Dividends:** rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established. Unless company declare dividend on the shares, it is not certain. Therefore it is recognised only when directors actually decides to pay dividend to their shareholders.

9.6 Effect of Uncertainties on Revenue Recognition

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. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.7 Disclosure

An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

The amount of turnover should be disclosed in the following manner on the face of the statement of profit and loss:

Turnover (Gross)	XXXXX
Less: Excise Duty	XXXXX
Turnover (Net)	XXXXX

The amount of excise duty to be shown as deduction from turnover should be the total excise duty for the year except the excise duty related to the difference between the closing inventory and opening inventory. The excise duty related to the difference between the closing inventory and opening inventory should be recognised separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

9.8 Illustrations

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:

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

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.

<u>Reference</u>: The students are advised to refer the full text of AS 9 "Revenue Recognition" (issued 1985).

UNIT 10 : AS 10: ACCOUNTING FOR FIXED ASSETS

10.1 Introduction

The standard deals with the accounting for tangible fixed assets. The standard does not take into consideration the specialized aspect of accounting for fixed assets reflected with the effects of price escalations but applies to financial statements on historical cost basis. It is important to note that after introduction of AS 16, 19 & 26, provisions relating to respective AS are held withdrawn and the rest is mandatory from the accounting year 1-4-2000. An entity should disclose (i) the gross and net book values of fixed assets at beginning and end of an accounting period showing additions, disposals, acquisitions and other movements, (ii) expenditure incurred on account of fixed assets in the course of construction or acquisition, (iii) revalued amounts substituted for historical costs of fixed assets with the method applied in computing the revalued amount.

This statement does not deal with accounting for the following items to which special considerations apply:

(i) Forests, plantations and similar regenerative natural resources.

(ii) Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

(iii) Expenditure on real estate development and

(iv) Biological assets ie living animals or plants

10.2 Identification of Fixed Assets

Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

10.3 Machinery Spares

Whether to capitalise a machinery spare or not will depend on the facts and circumstances of each case. However, the machinery spares of the following types should be capitalised being of the nature of capital spares/insurance spares -

- Machinery spares which are specific to a particular item of fixed asset, i.e., they can be used only in connection with a particular item of the fixed asset and their use is expected to be irregular.
- Machinery spares of the nature of capital spares/insurance spares should be capitalised separately at the time of their purchase whether procured at the time of purchase of the

fixed asset concerned or subsequently. The total cost of such capital spares/insurance spares should be allocated on a systematic basis over a period not exceeding the useful life of the principal item, i.e., the fixed asset to which they relate.

- When the related fixed asset is either discarded or sold, the written down value less disposal value, if any, of the capital spares/insurance spares should be written off.
- The stand-by equipment is a separate fixed asset in its own right and should be depreciated like any other fixed asset.

10.4 Components of Cost

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value. The cost of an item of fixed asset comprises

(1) Its purchase price, including import duties and other non-refundable taxes or levies

(2) Any directly attributable cost of bringing the asset to its working condition for its intended use;

(3) The initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located, the obligation for which the enterprise incurred either when the item was acquired, or as a consequence of having used the asset during a particular period for purposes other than to produce inventories during that period.

Any trade discounts and rebates are deducted in arriving at the purchase price. The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments and changes in duties or similar factors.

The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

10.5 Self-constructed Fixed Assets

The cost of a self-constructed asset is determined using the same principles as for an acquired asset

The Standard states that if an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing the asset for sale, in accordance with the principles of AS 2 Valuation of Inventories.

Administration and other general overhead costs are not a component of the cost of tangible fixed asset because they cannot be directly attributed to the acquisition of the asset or bringing the asset to its working condition.

The following principles also apply:

- any internal profits are eliminated in arriving at the cost of an asset;
- the costs of abnormal amounts of wasted material, labour or other resources incurred in the production of the self-constructed asset are excluded from its cost; and
- borrowing costs incurred during the period of production will be included in accordance with AS 16 'Borrowing Costs' if the self-constructed asset meets the definition of a qualifying asset

Illustration 1

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

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

Calculate the cost of fixed assets.

Solution

Calculation of the cost of construction of Assets

Particulars	₹
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

10.6 Non-monetary Consideration

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

10.7 Improvements and Repairs

Any expenditure that increase the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. A computer with 20GB hard disk crashed and was replaced with a 80GB hard disk, will be capitalised and added to the cost of the computer.The cost of an addition or extension to an existing asset, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately. Current engine of an aircraft replaced with the new one on being damaged beyond repairs will be treated as a separate asset, as it has its own separate identity.

10.8 Amount Substituted for Historical Cost (Revaluation)

When a tangible fixed asset is revalued, the entire class of tangible fixed assets to which that asset belongs is required to be revalued. Assets within a class of tangible fixed assets are revalued simultaneously to avoid selective revalution of assets and the reporting of amounts in the financial statements that are a mixture of costs and valuations at different dates. This is intended to prevent the distortions caused by selective use of revalution, so as to take credit for gains without acknowledging falls in the value of similar assets.

The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis. It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class. An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. Journal entry is as follow:

Fixed Asset Account Dr.

To Revaluation Reserve Account

A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve.

For example, Journal entry for decrease in the value of the asset on revaluation from ₹ 1,00,000 to ₹ 70,000, if Revaluation Reserve is appearing at ₹ 10,000 will be done as:

Revaluation Reserve Account	Dr.	₹ 10,000	
Loss on Revaluation Account	Dr.	₹ 20,000	
To Fixed Assets Account			₹ 30,000

10.9 Retirements and Disposals (derecognition)

The carrying amount of a tangible fixed asset should be derecognised:

- on disposal; or
- when no future economic benefits are expected from its use or disposal

Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

For example, the journal entries for the sale of an asset for ₹ 1,00,000 appearing in the books at ₹ 1,15,000, if Revaluation Reserve is appearing at ₹ 20,000 will be as follow:

Bank Account	Dr.	₹ 1,00,000	
Revaluation Reserve Account	Dr.	₹ 15,000	
To Fixed Assets Account			₹ 1,15,000
Revaluation Reserve Account	Dr.	₹ 5,000	
To General Reserve Account			₹ 5,000

10.10 Hire Purchases

In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

10.11 Joint Ownership

Where an enterprise owns fixed assets jointly with others, the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

10.12 Goodwill

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

10.13 Disclosure

(i) Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;

(ii) Expenditure incurred on account of fixed assets in the course of construction or acquisition; and

(iii) Revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

10.14 Illustrations

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:

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

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

Particulars		₹
Cost of Land		5,00,000
Legal Fees		25,000
Title Insurance		10,000
Cost of Demolition	50,000	
Less: Salvage value of Material	(10,000)	40,000
Cost of the Asset		5,75,000

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	(7.00)		
	343.00		
Add: 8% Sales tax (8% × ₹ 343 lakhs)	27.44	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	0.15	0.75	
Total cost		383.07	

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

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

Reference: The students are advised to refer the full text of AS 10 "Accounting for Fixed Assets" (issued 1985).

UNIT 11 : AS 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

11.1 Introduction

AS 11, (revised 2003), comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognize the financial effects of changes in exchange rates in the financial statements. The standard requires the enterprises to disclose

(i) the amount of exchange differences included in the net profit or loss for the period

(ii) the amount of exchange differences adjusted in the carrying amount of fixed assets,

(iii) the amount of exchange differences in respect of forward exchange contracts to be recognized in the profit or loss in one or more subsequent accounting periods (over the life of the contract).

11.2 Scope

This Statement should be applied:

(a) In accounting for transactions in foreign currencies.

(b) In translating the financial statements of foreign operations.

(c) This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

This Statement does not:

(a) Specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, the Standard requires disclosure of the reasons for using that currency. The Standard also requires disclosure of the reason for any change in the reporting currency.

(b) Deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation, which are addressed in AS 3 'Cash flow statement'.

(c) Deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

(d) Deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

11.3 Definitions of the terms used in the Standard

A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) Buys or sells goods or services whose price is denominated in a foreign currency.

(b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.

(c) Becomes a party to an unperformed forward exchange contract or

(d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables.

Non-monetary items are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares.

Foreign operation is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations.

Non-integral foreign operation is a foreign operation that is not an integral foreign operation. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

'Net investment in a non-integral foreign operation' is the reporting enterprise's share in the net assets of that operation.

Forward exchange contract means an agreement to exchange different currencies at a forward rate.

Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.

'Foreign currency' is a currency other than the reporting currency of an enterprise

11.4 Initial Recognition

A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

A rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

11.5 Reporting at each balance sheet date

The treatment of foreign currency items at the balance sheet date depends on whether the item is:

- monetary or non-monetary; and
- carried at historical cost or fair value (for non-monetary items).

(a) Foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from or required to disburse, such item at the balance sheet date.

(b) Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.

(c) Non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

(d) The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

11.6 Recognition of Exchange Differences

Exchange differences arise on:

- the settlement of monetary items at a date subsequent to intial recognition; and
- remeasuring an enterprise's monetary items at rates different from those at which they were either initially recorded (if in the period) or previously recorded (at the previous balance sheet date).

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

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 recognised as income or as expenses in the period in which they arise.

Note:

Central Government in consultation with National Advisory Committee on Accounting Standards made an amendment to AS 11 "The Effects of Changes in Foreign Exchange Rates" in the form of Companies (Accounting Standards) Amendment Rules, 2009 and 2011.

According to the recent Notification, 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, insofar 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, and in other cases, can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods) but not beyond 31st March, 2020.

Ministry of Corporate Affairs vide its notification number G.S.R 913(E), dated 29th December, 2011, has amended the para 46 of AS 11 of the Companies (Accounting Standards) Amendment Rules, 2011. Through this notification, the MCA has extended the option (for the enterprises) to capitalize the exchange differences arising on reporting of long term foreign currency monetary items till 31st March, 2020 instead of 31st March, 2012. Thus the treatment availed at the option of the company shall be irrevocable and shall be exercised till 31st March, 2020.

Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option shall be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

If the above option is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

Insertion of para 46A in Accounting Standard 11 of the Companies (Accounting Standards) Rules, 2006

Ministry of Corporate Affairs vide its notification number G.S.R 914(E), dated 29th December, 2011, inserted under-mentioned para 46A in AS 11 of the Companies (Accounting Standards) Rules, 2006, now known as Companies (Accounting Standards) (Second Amendment) Rules, 2011.

"46A. (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (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 assets, can be added to or deducted from the cost of the assets and shall be depreciated over the balance life of the assets, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability.

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Note: The principal regulations were published in the Gazette of India Extraordinary, Part II, Section 3, Sub Section (i) vide G.S.R 739(E), dated the 7th December, 2006 and amended vide notification number G.S.R. 212(E), dated the 27th March, 2008 and subsequently amended by No. G.S.R. 225(E) dated 31st March, 2009 and No. G.S.R. 378(E), dated 11th May, 2011.

11.7 Classification of Foreign Operations as Integral or Non-integral

The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either 'integral foreign operations' or 'non-integral foreign operations'.

An integral foreign operation carries on its business as if it were an extension of the reporting enterprise's operations. For example, such an operation might only sell goods imported from the reporting enterprise and remits the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transctions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non- monetary items held by the non-integral foreign operation.

11.8 Translation of Foreign Integral Operations

The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

11.9 Translation of Non-Integral Foreign Operations

The translation of the financial statements of a non-integral foreign operation is done using the 'closing rate method' in which the following procedures are used:

(a) The assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

(b) Income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

(c) All resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.

(d) For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period is often used to translate income and expense items of a foreign operation.

(e) Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate.

(f) A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

(g) The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (AS 21 and AS 27). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.

(h) When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise (AS 21).

(i) The exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

(j) An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

(a) While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.

(b) Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.

(c) The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.

(d) Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.

(e) The foreign operation's sales are mainly in currencies other than the reporting currency.

(f) Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.

(g) Sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.

(h) There is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

11.10 Change in the Classification of a Foreign Operation

When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve.

When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

11.11 Tax Effects of Exchange Differences

Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22.

11.12 Forward Exchange Contract

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract.

Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

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	(₹ 47.10)
Premium on Contract	₹ 0.08
Contract Amount	US$ 1,00,000
Total Profit (1,00,000 x 0.08)	₹ 8,000

11.13 Disclosure

An enterprise should disclose:

(a) The amount of exchange differences included in the net profit or loss for the period.

(b) Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) The nature of the change in classification;

(b) The reason for the change;

(c) The impact of the change in classification on shareholders' funds; and

(d) The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

Presentation of Foreign Currency Monetary Item Translation Difference Account (FCMITDA)

In the Revised Schedule VI format, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". Therefore, the Council of the Institute at its 324th meeting held on March 24-26, 2013 at

New Delhi, considered the issue regarding the presentation of the FCMITDA in the balance sheet.

The Council considered the definition of an asset given in the Framework on Preparation and Presentation of Financial Statements issued by ICAI which states as follows:

"An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

Since the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Therefore, such balance cannot be reflected as an asset. Accordingly, the Council decided that debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

11.14 Miscellaneous Illustrations

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:

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

Exchange difference = 75 lakhs US Dollars × (42.50 – 40.00)

= ₹ 187.50 lakhs

(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 date 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
Exhange rate on 1st April, 2011		₹ 52 = 1$
Cost of the asset in ₹	($ 10 lakhs x ₹ 52)	520 lakhs
Less: Exchange differences as on 31st 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)
		461 lakhs

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.

Reference: The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates" (revised 2003).

UNIT 12 : AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

12.1 Introduction

The Standard comes into effect in respect of accounting periods commencing on or after 1.4.1992 and will be recommendatory in nature for an initial period of two years. AS 12 deals with accounting for government grants like subsidies, cash incentives, duty drawbacks, etc. and specifies that the government grants should not be recognized until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received. The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets, related to revenue, related to promoters' contribution; treatment for refund of government grants etc. The enterprises are required to disclose

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

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

This Statement does not deal with:

(i) The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.

(ii) Government assistance other than in the form of government grants.

(iii) Government participation in the ownership of the enterprise.

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

12.2 Accounting Treatment of Govternment Grants

Two broad approaches may be followed for the accounting treatment of government grants:

- the 'capital approach', under which a grant is treated as part of shareholders' funds, and
- the 'income approach', under which a grant is taken to income over one or more periods.

Those in support of the **'capital approach'** argue as follows:

(i) Many government grants are in the nature of promoters' contribution, i.e., they are given by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants.

(ii) They are not earned but represent an incentive provided by government without related costs.

Arguments in support of the **'income approach'** are as follows:

(i) The enterprise earns grants through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

(ii) As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

(iii) In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

12.3 Recognition of Government Grants

A government grant is not recognised until there is reasonable assurance that:

- the enterprise will comply with the conditions attaching to it; and
- the grant will be received.

Receipt of a grant is not of itself conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

12.4 Non-monetary Government Grants

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

12.5 Presentation of Grants Related to Specific Fixed Assets

Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives.

Under one method, the grant is shown as a deduction from the gross value of the asset concerned 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. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income.

12.6 Presentation of Grants Related to Revenue

AS 12 permits two methods of presentation in the financial statements for grants related to income:

1. directly as a credit to the statement of profit and loss, either separately or under a general heading such as 'other income'; or
2. as a deduction in reporting the related expense.

12.7 Presentation of Grants of the nature of Promoters' contribution

Where the government grants are of the nature of promoters' contribution, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

12.8 Refund of Government Grants

Government grants sometimes become refundable because certain conditions are not fulfilled and is treated as an extraordinary item (AS 5).

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable.

Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

12.9 Disclosure

(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 statements, including grants of non-monetary assets given at a concessional rate or free of cost.

12.10 Miscellaneous Illustrations

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%	(240.00)
	Book value	960.00
31st March, 2011	*Less*: Depreciation @ 20%	(192.00)
	Book value	768.00
31st March, 2012	*Less*: Depreciation @ 20%	(153.60)
1st April, 2012	Book value	614.40
May, 2012	*Add*: Refund of grant	300.00
	Revised book value	914.40

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.

Reference: The students are advised to refer the full text of AS 12 "Accounting for Government Grants" (issued 1991).

Note: Exposure Draft on Limited Revision of AS 12 has recently been issued by the ICAI to synchronize the presentation requirements of AS 12, Accounting for Government Grants, with the presentation requirements prescribed under revised Schedule VI to the Companies Act, 1956. It is pertinent to note that this Limited Revision is still is the form of exposure draft and will come into effect as and when it will be notified by the Government.

UNIT 13 : AS:13 ACCOUNTING FOR INVESTMENTS

13.1 Introduction

This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995. The statement deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the current investments (realizable in nature and intended to be held for not more than one year from the date of its acquisition) and long terms investments (other than current investments) distinctly in their financial statements. An investment property should be accounted for as long-term investments. The cost of investments should include all acquisition costs (including brokerage, fees and duties) and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

This Statement does not deal with:

a. The basis for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.
b. Operating or finance leases.
c. Investments on retirement benefit plans and life insurance enterprises and
d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act.

13.2 Definition of the terms used in the Standard

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 inventory-in-trade are not 'investments'

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

13.3 Forms of Investments

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings).For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

13.4 Classification of Investments

A **current investment** is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. The intention to hold for not more than one year is to be judged at the time of purchase of investment.

A **long term investment** is an investment other than a current investment.

13.5 Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties etc.If an investment is acquired, or partly acquired, by the issue of shares or other securities or another assets, the acquisition cost is the fair value of the securities issued or assets given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

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. However, 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.

13.6 Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value.

Any reduction in realisable value is debited to profit and loss account, however if realisable value of investment is increased subsequently, the increase in value of current investment to the level of the cost is credited to profit and loss account.

Long-term investments are usually carried at cost. Where there is a decline, other than temporary, in the carrying amounts of long term valued investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

13.7 Investment Properties

An **investment property** is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. The cost of any shares in a 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.

13.8 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. 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.

13.9 Reclassification of Investments

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

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.

13.10 Disclosure

The following disclosures in financial statements in relation to investments are appropriate: -

a. The accounting policies followed for valuation of investments.

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

   i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.

   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.

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

d. The aggregate amount of quoted and unquoted securities separately.

e. Other disclosures as specifically required by the relevant statute governing the enterprise.

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 quiet 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.

Reference: The students are advised to refer the full text of AS 13 "Accounting for Investments" (issued 1993).

UNIT 14 : AS 14: ACCOUNTING FOR AMALGAMATIONS

14.1 Introduction

This standard has come into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature. AS 14 deals with accountingthe accounting to be made in the books of Transfree company in the case of amalgamation and the treatment of any resultant goodwill or reserve.

An amalgamation may be either in the nature of merger or purchase. The standard specifies the conditions to be satisfied by an amalgamation to be considered as amalgamation in nature of merger or purchase.

An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method.

The standard describes the disclosure requirements for both types of amalgamations in the first financial statementsThis statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises. We will discuss the other amalgamation aspects in detail in the next paragraphs of this unit.

This statement does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

14.2 Definition of the terms used in the Standard

- Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.
- Transferor company means the company which is amalgamated into another company.
- Transferee company means the company into which a transferor company is amalgamated.

14.3 Types of Amalgamations

Amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. These are known as Amalgamation in nature of merger. Other is known as Amalgamation in nature of purchase.

14.4 Amalgamation in the Nature of Merger

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

(i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

(ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

(iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

(iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

(v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

14.5 Amalgamation in the Nature of Purchase

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above.

14.6 Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations.

- the pooling of interests method and
- the purchase method.

14.6.1 Pooling of interests Method: Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts.

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

14.6.2 Purchase Method: Under the purchase method, the transferee company accounts for the amalgamation either

- By incorporating the assets and liabilities at their existing carrying amounts or
- By allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [AS 4].

14.7 Treatment of Reserves of the Transferor Company on Amalgamation

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. Adjustments to reserves

When an amalgamation is accounted for using the pooling of interests method, the reserves of the transferee company are adjusted to give effect to the following:

- Conflicting accounting policies of the transferor and the transferee. A uniform set of accounting policies should be adopted following the amalgamation and, hence, the policies of the transferor and the transferee are aligned. The effects on the financial statements of this change in the accounting policies is reported in accordance with AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'
- Difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company.

If the amalgamation is an 'amalgamation in the nature of purchase', the amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve. In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity. Certain reserves may have been created by the transferor company pursuant to the requirements of certain acts, referred to hereinafter as 'statutory reserves'. Such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

14.8 Treatment of Goodwill Arising on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

14.9 Disclosures

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Names and general nature of business of the amalgamating companies;

b. Effective date of amalgamation for accounting purposes;

c. The method of accounting used to reflect the amalgamation; and

d. Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation;

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Consideration for the amalgamation and a description of the consideration paid or contingently payable; and

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

14.10 Miscellaneous Illustrations

Illustration 1

A Ltd. take over B Ltd. on April 01, 2012 and discharges consideration for the business as follows:

(i) Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.

(ii) Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders (₹ 1,70,000) of B Ltd. at a premium of 10%.

(iii) It is agreed that the debentures of B Ltd. (₹ 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.

Solution

Particulars	₹
Equity Shares (42,000 x 10)	4,20,000
Preference Share Capital	1,70,000
Add: Premium on Redemption	17,000
Purchase Consideration	6,07,000

Illustration 2

The following are the summarised Balance Sheets of Big Ltd. and Small Ltd. as at 31.3.2012:

(₹ in lakhs)

	Big Ltd. ₹	*Small Ltd.* ₹		*Big Ltd.* ₹	*Small Ltd.* ₹
Share Capital	*40.0*	*15.0*	*Sundry Assets (including cost of shares)*	*56.0*	*20.0*
Profit & Loss A/c	*7.5*	*--*	*Goodwill*	*4.0*	*5.0*
Trade Payables	*12.5*	*12.5*	*Profit and Loss A/c*	*--*	*2.5*
	60.0	*27.5*		*60.0*	*27.5*

Additional Information:

(i) The two companies agree to amalgamate and form a new company, Medium Ltd.

(ii) Big Ltd. holds 10,000 shares in Small Ltd. acquired at a cost of ₹ 2,50,000 and Small Ltd. holds 5,000 shares in Big Ltd. acquired at a cost of ₹ 7,00,000.

(iii) The shares of Big Ltd. are of ₹ 100 and are fully paid and the shares of Small Ltd. are of ₹ 50 each on which ₹ 30 has been paid-up.

(iv) It is agreed that the goodwill of Big Ltd. would be valued at ₹ 1,50,000 and that of Small Ltd. at ₹ 2,50,000.

(v) The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuation decided as given in (iv).

(vi) The new shares are to be of a nominal value of ₹ 50 each credited as ₹ 25 paid.

You are required to:

(i) Prepare the Balance Sheet of Medium Ltd., as at 31st March, 2012 after giving effect to the above transactions; and

(ii) Prepare a statement showing the shareholdings in the new company attributable to the shareholders of the merged companies.

Solution

(i) Balance Sheet of Medium Ltd. as on 31st March, 2012

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		45,50,000
(2) Current Liabilities		
Trade Payable		25,00,000
Total		70,50,000
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets	1	66,50,000
Intangible assets	2	4,00,000
Total		70,50,000

Notes to Accounts:

	(₹)
1. Tangible Assets	
Sundry Assets (₹ 53,50,000 + ₹ 13,00,000)	66,50,000
2. Intangible Assets	
Goodwill (₹ 1,50,000 + ₹ 2,50,000)	4,00,000

(ii) Statement of Shareholding in Medium Ltd.

	Big Ltd. ₹	*Small Ltd.* ₹
Total value of Assets	44,20,513	8,52,564
Less: Pertaining to shares held by the other company	(5,52,564)	(1,70,513)
	38,67,949	6,82,051
Rounded off to	38,67,950	6,82,050
Shares of new company (at ₹ 25 per share)	1,54,718	27,282

Total purchase consideration to be paid to Big Ltd and Small Ltd. (₹ 38,67,950 + ₹ 6,82,050)	₹ 45,50,000
Number of shares in Big Ltd. (40,00,000/100)	40,000 shares
Number of shares in Small Ltd. (15,00,000/30)	50,000 shares
Holding of Small Ltd. in Big Ltd. (5,000/40,000)	1/8
Holding of Big Ltd. in Small Ltd. (10,000/50,000)	1/5
Number of shares held by outsiders in Big Ltd. (40,000 – 5,000) =	35,000
Number of shares held by outsiders in Small Ltd. (50,000 – 10,000)	40,000

Workings Note:

Calculation of Book Value of Shares

	Big Ltd ₹	*Small Ltd.* ₹
Goodwill	1,50,000	2,50,000
Sundry Assets other than shares in other company		
₹ (56,00,000 – 2,50,000)	53,50,000	
₹ (20,00,000 – 7,00,000)		13,00,000
	55,00,000	15,50,000
Less: Trade receivables	(12,50,000)	(12,50,000)
	42,50,000	3,00,000

If "x" is the Book Value of Assets of Big Ltd and "y" of Small Ltd.

$x = 42{,}50{,}000 + \frac{1}{5}y$

$y = 3{,}00{,}000 + \frac{1}{8}x$

$x = 42{,}50{,}000 + \frac{1}{5}(3{,}00{,}000 + \frac{1}{8}x)$

$= 42{,}50{,}000 + 60{,}000 + \frac{1}{40}x$

$\frac{39}{40}x = 43{,}10{,}000$

$x = 43{,}10{,}000 \times \frac{40}{39}$

$x = 44{,}20{,}513$ (approx.)

$y = 3{,}00{,}000 + \frac{1}{8}(44{,}20{,}513)$

$= 3{,}00{,}000 + 5{,}52{,}564$

$=$ ₹ 8,52,564 (approx.)

Book Value of one share of Big Ltd. = $\frac{44{,}20{,}513}{40{,}000}$ = ₹ 110.513 (approx.)

Book Value of one share of Small Ltd. = $\frac{8{,}52{,}564}{50{,}000}$ = ₹ 17.05 (approx.)

Illustration 3

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2012. A new company C Ltd. was formed to take over the business of the existing companies. The summarised Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2012 are given below:

	(₹ in lakhs)			(₹ in lakhs)	
Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Share Capital			*Fixed Assets*		
Equity Shares of ₹ 100 each	*800*	*750*	*Land and Building*	*550*	*400*
12% Preference shares of ₹ 100 each	*300*	*200*	*Plant and Machinery*	*350*	*250*
Reserves and Surplus			*Investments*	*150*	*50*
Revaluation Reserve	*150*	*100*	*Current Assets, Loans and Advances*		
General Reserve	*170*	*150*			
Investment Allowance Reserve	*50*	*50*	*Inventory*	*350*	*250*
Profit and Loss Account	*50*	*30*	*Trade Receivables*	*300*	*350*
Secured Loans					
10% Debentures (₹ 100 each)	*60*	*30*	*Cash and Bank*	*300*	*200*
Current Liabilities and provisions					
Trade Payables	*420*	*190*			
	2,000	*1,500*		*2,000*	*1,500*

Additional Information:

(1) 10% Debentureholders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of ₹ 100 each so as to maintain the same amount of interest.

(2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of ₹ 150 per share (face value of ₹ 100).

(3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ ₹ 30 each, having a face value of ₹ 10 per share.

(4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 2012 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Solution

Balance Sheet of C Ltd.
as at 1st April, 2012

Particulars	Note No.	(₹ in lakhs)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,200
(b) Reserves and Surplus	2	1,750
(2) Non-Current Liabilities		
Long-term borrowings	3	60
(3) Current Liabilities		
Trade payables	9	610
Total		3,620
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
i. Tangible assets	4	1,550
ii. Intangible assets	5	20
(b) Non-current investments	6	200
(c) Other non-current assets	7	100
(2) Current assets		
(a) Inventory		600
(b) Trade receivables	8	650
(c) Cash and cash equivalents		500
Total		3,620

Notes to Accounts

		(₹ in lakhs)	(₹ in lakhs)
1.	Share Capital		
	Equity share capital (W.N.2)		
	70,00,000 Equity shares of ₹ 10 each	700	
	5,00,000 Preference shares of ₹ 100 each	500	
	(all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)		1,200
2.	Reserves and surplus		
	Securities Premium Account	1,650	
	Investment Allowance Reserve	100	1,750
3.	Long-term borrowings		
	15% Debentures		60
4.	Tangible assets		
	Land and Building	950	

	Plant and Machinery	600	1,550
5.	Intangible assets		
	Goodwill [W.N. 2]		20
6.	Non-current Investments		
	Investments		200
7.	Other non-current assets		
	Amalgamation Adjustment Account		100
8.	Trade receivables		
			650
9.	Trade payables		610

Working Notes:

		(₹ in lakhs)	
		A Ltd.	*B Ltd.*
(1)	Computation of Purchase consideration		
	(a) Preference shareholders:		
	$\left(\frac{3,00,00,000}{100} \text{ i.e. } 3,00,000 \text{ shares}\right) \times ₹\,150 \text{ each}$	450	
	$\left(\frac{2,00,00,000}{100} \text{ i.e. } 2,00,000 \text{ shares}\right) \times ₹\,150 \text{ each}$		300
	(b) Equity shareholders:		
	$\left(\frac{8,00,00,000 \times 5}{100} \text{ i.e. } 40,00,000 \text{ shares}\right) \times ₹\,30 \text{ each}$	1,200	
	$\left(\frac{7,50,00,000 \times 4}{100} \text{ i.e. } 30,00,000 \text{ shares}\right) \times ₹\,30 \text{ each}$		900
	Amount of Purchase Consideration	1,650	1,200
(2)	Net Assets Taken Over		
	Assets taken over:		
	Land and Building	550	400
	Plant and Machinery	350	250
	Investments	150	50
	Inventory	350	250
	trade receivables	300	350
	Cash and bank	300	200
		2,000	1,500

	Less: Liabilities taken over:				
	Debentures	40		20	
	Trade payables	420		190	
			460		210
	Net assets taken over		1,540		1,290
	Purchase consideration		1,650		1,200
	Goodwill		110		
	Capital reserve				90

Note:

Since, Investment Allowance Reserve is to be maintained for 4 more years, it is carried forward by a corresponding debit to Amalgamation Adjustment Account in accordance with AS-14. Though, Revised Schedule VI (Now Schedule III in Companies Act, 2013) does not mention disclosure of "miscellaneous expenditure", since additional line items can be added on the face or in the notes, unamortised portion of such items can be disclosed (both 'current' as well as 'non-current' portion), under the head 'other current/non-current assets' depending on whether the amount will be amortised in the next 12 months or thereafter.

Reference: The students are advised to refer the full text of AS 14 "Accounting for Amalgamations" (issued 1994).

UNIT 15 : AS 15: EMPLOYEE BENEFITS

15.1 Introduction

The revised Accounting Standard 15 - 'Employee Benefits' (AS 15), generally deals with all forms of employee benefits all forms of consideration given by an enterprise in exchange for services rendered by employees (other than inventory compensation for which a separate guidance note is promulgated), many of which were not dealt with by pre-revised AS 15. The Standard addresses only the accounting of employee benefits by employers. The Standard makes four things very clear at the outset:

(i) the Standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff;

(ii) employee benefits can be paid in cash or in kind ;

(iii) employee benefits include benefits provided to employees and their dependents (spouses, children and others); and

(iv) payment can be made directly to employees, their dependent or to any other party (e.g., insurance companies, trust etc.).

Employee benefits include:

(a) Short-term employee benefits (e.g. wages, salaries, paid annual leave and sick leave, profit sharing bonuses etc.(payable within 12 months of the year-end) and non-monetary benefits for current employees;

(b) Post-employment benefits (e.g., gratuity, pension, provident fund, post-employment medical care etc.);

(c) long-term employee benefits (e.g., long-service leave, long-term disability benefits, bonuses not wholly payable within 12 months of the year end etc.); and

(d) termination benefits (e.g. VRS payments)

The Standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.

15.2 Applicability

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. This standard is applicable predominantly for Level 1 enterprises, and applied to other entities with certain relaxations as mentioned in Appendix III at the end of the Study Material (Volume II).

15.3 Meaning of the term "Employee Benefits"

The term employee is not defined under the standard AS 15 does not define who is an 'employee', but states in that "an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel". This suggests that the intention was for the term 'employee' to apply more widely than simply to persons with a contract of employment as 'casual' and 'temporary' staff may frequently not have such contracts.

The following indicators may suggest an employee relationship may be more likely to exist, and may help in making individual judgements:

- A contract of employment exists;
- Individuals are considered employees for legal/tax/social security purposes;
- There is a large amount of oversight and direction by the employer and necessary tools, equipment and materials are provided by the employer;
- Services are performed at a location specified by the employer;

Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:

- Has no other clients;
- Has served the employer for a long period;
- Faces little or no financial risk;
- Requires the explicit permissions of the employer to concurrently undertake additional employment elsewhere.

15.4 Short-term Employee Benefits

Short-term employee benefits (other than termination benefits) are payable within twelve months after the the end of the period in which the service is rendered. Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost. Short-term employee benefits are broadly classified into four categories:

(i) regular period benefits (e.g., wages, salaries);

(ii) short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);

(iii) profit sharing and bonuses payable within twelve months after the end of the period in which employee render the related services and

(iv) non-monetary benefits (e.g., medical care, housing, cars etc.)

The Standard lays down a general recognition criteria for all short-term employee benefits. There are further requirements in respect of short-term compensated absences and profit sharing and bonus plans. The general criteria says that an enterprise should recognize as an expense (unless another accounting standard permits a different treatment) the undiscounted amount of all short-term employee benefits attributable to services that been already rendered in the period and any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate.

The expected cost of accumulating compensated absences should be recognized when employees render the service that increase their entitlement to future compensated absences. 'An enterprise should measure the expected cost of accumulating compensated absences as the *additional amount* that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'. No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

Non-accumulating compensated absences (e.g., maternity leave) do not carry forward and are not directly linked to the services rendered by employees in the past. Therefore, an enterprise recognizes no liability or expense until the time of the absence. In other words the cost of non-accumulating absences should be recognized as and when they arise.

Recognition of expenses for profit sharing and bonus plans would depend on fulfillment of conditions mentioned the Standard. The conditions are:

(a) Enterprise has a present obligation to make such payments as a result of past events; and

(b) Reliable estimate of the obligation can be made.

The second condition can be satisfied only when the profit sharing and bonus plans contained a formula for determining the amount of benefit. The enterprise should recognize the expected cost of profit sharing and bonus payments in the financial statements.

15.5 Post Employment Benefits: Defined Contribution vs Defined Benefits

The accounting treatment and disclosures required for a post-employment benefit plan depend upon whether it is a defined contribution or a defined benefit plan. In addition to addressing defined contribution and defined benefit plans generally, the Standard also gives guidance as to how its requirements should be applied to insured benefits, multi-employment benefit plans.Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further` contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. In defined benefits plans, the actuarial and investment risk fall on the employer.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

15.6 Is the gratuity scheme a defined contribution or defined benefit scheme?

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either:

(a) pay the employee benefits directly when they fall due;

(b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

On the asset side, a question arises as to whether the funds under the scheme as certified by LIC would be treated as plan assets or reimbursement rights. The distinction is important (though both are measured on fair valuation basis) because plan assets are reduced from the defined benefit obligation and the net amount is disclosed in the balance sheet, whereas, in the case of reimbursement rights, the defined benefit obligation and the reimbursement rights are shown separately as liability and asset on the balance sheet. This would have the impact of making the balance sheet heavy both on the asset side as well as the liabilities side.

15.7 Other Long Term Employee Benefits

Other long-term employee benefits include, for example:

(a) long-term compensated absences such as long-service or sabbatical leave;

(b) jubilee or other long-service benefits;

(c) long-term disability benefits;

(d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and

(e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

15.8 Termination Benefits

Termination Benefits are employee benefits payable as a result of either an enterprise's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept voluntary redundancy in exchange for those benefits (e.g., payments under VRS). Termination benefits are recognized by an enterprise as a liability and an expense only when the enterprise has

(i) a detailed formal plan for the termination which is duly approved, and

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

Where the termination benefits fall due within twelve months after the balance sheet date, an *undiscounted* amount of such benefits should be recognized as liability in the balance sheet with a corresponding charge to Profit & Loss Account. However, when the termination benefits fall due more than twelve months after the balance sheet date, such benefits should be discounted using an appropriate discount rate. Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees expected to accept the offer. Where there is uncertainty with regard to the number of employees who will accept an offer of voluntary redundancy, a contingent liability exists and should be so disclosed as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

15.9 Accounting Treatment

In the Balance Sheet of the enterprise, 'the amount recognized as a defined benefit liability should be the net total of the following amounts:

(a) the present value of the defined benefit obligation at the balance sheet date;

(b) *minus* any past service cost not yet recognized;

(c) *minus* the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.'

In case where fair value of plan assets is high, it may so happen that the net amount under defined benefit liability turns negative (giving rise to net assets). A S 15 states that the enterprise, in such a situation, should measure the resulting asset at the lower of:-

(i) the amount so determined; and

(ii) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The recognition of expenses relating to defined benefits in the Profit and Loss Account is stated in Para 61 of the Standard. The Standard identifies *seven* components of defined employee benefit costs:

(a) current service cost;

(b) interest cost;

(c) the expected return on any plan assets (and any reimbursement rights);

(d) actuarial gains and losses (to the extent they are recognized);

(e) past service cost (to the extent they are recognized);

(f) the effect of any curtailments or settlements; and

(g) the extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(ii) of the Standard.

The item (f) above needs explanation. A settlement occurs when an employer enters into a transaction that eliminates all further legal or constructive obligations for part or whole of the benefits provided under a defined benefit plan. For example, the commuted portion of pension. A curtailment occurs when an employer either commits to reduce the number of employees covered by a plan or reduces the benefits under a plan. The gains or losses on the settlement or curtailment of a defined benefit plan should be recognized when the settlement or curtailment occurs.

15.10 Disclosures

Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists.

As required by AS 29, *"Provisions, Contingent Liabilities and Contingent Assets"* an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

As required by AS 5, *"Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies"* an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period.

Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

Where required by AS 18, *"Related Party Disclosures"*, an enterprise discloses information about termination benefits for key management personnel

When drafting AS 15 (revised), the standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallized at this stageh. Revised AS 15 (2005) requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

As per the transitional provision of revised AS 15, as regards VRS as paid upto 31 March, 2009, there is a choice to defer it over pay back period, subject to prohibition on carry forward to periods commencing on or after 1 April, 2010.

15.11 Actuarial Assumptions

The actuarial assumptions should be unbiased and mutually compatible. They are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. They should be neither imprudent nor excessively conservative, and should reflect the economic relationships between factors such as inflation, rates of salary increase, return on plan assets and discount rates.

AS 15 explains that actuarial assumptions comprise:

(a) demographic assumptions about the future characteristics of current and former employees (and their dependants) who are eligible for benefits. Demographic assumptions deal with matters such as:

   (i) mortality, both during and after employment;

   (ii) rates of employee turnover, disability and early retirement;

   (iii) the proportion of plan members with dependants who will be eligible for benefits;

   (iv) claim rates under medical plans; and

(b) financial assumptions, dealing with items such as:

(i) the discount rate

(ii) future salary and benefit levels

(iii) in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments and

(iv) the expected rate of return on plan assets.

Financial assumptions: Financial assumptions should be based on market expectation at the balance sheet date for the period over which the post-employment benefit obligations will be settled. Discount rates and other financial assumptions should not be inflation-adjusted unless such measures are more reliable (eg where benefits are index-linked)

15.12 Actuarial Gains and Losses

Actuarial gains and losses comprise:

- experience adjustments (the effects of difference between the previous actuarial assumptions and what has actually occurred); and
- the effects of changes in actuarial assumptions.

Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. While this is the general principle, as per AS 15, in case an enterprise adopts the option to defer the recognition of any subsequent actuarial gains is limited to excess of cumulative (unrecognized gains) over the unrecognized portion of increase in transitional liability.

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	*(1.00)*
Expected Rate of Return	*10.25*

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)		1,500
Expected return on plan assets for 2011-12		11,750
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	49,000	(1,49,000)
		1,000
Add: Benefits paid		19,000
Actual return on plan assets		20,000

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:

(a) Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.

(b) 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	582

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	(5,100)
	300
Less: Unamortised past service cost (90% of ₹ 180)	(162)
Liability to be recognised in the balance sheet	138

Reference: The students are advised to refer the full text of AS 15 (Revised "Employee Benefits" (revised 2005).

UNIT 16 : AS 16: BORROWING COSTS

16.1 Introduction

The standard prescribes the accounting treatment for borrowing costs (i.e. interest and other costs) incurred by an enterprise in connection with the borrowing of funds. Borrowing costs are required to be capitalized as part of a qualifying asset (an asset that takes a substantial period of time to get ready for its intended use), if it is directly attributable towards its acquisition, construction or production. Upon such capitalization, the carrying amount of assets should be assessed as to whether it is greater than its recoverable amount or net realizable value and adjustments are required to be made in accordance with other standards. The amount of borrowing costs eligible for capitalization should be determined in accordance with AS 16 and other borrowing costs (not eligible for capitalization) should be recognized as expenses in the period in which they are incurred. This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature. This Statement does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

16.2 Borrowing Costs

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

Borrowing costs may include:

a. Interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

b. Amortisation of any discounts or premiums relating to borrowings;

c. Amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

d. Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

e. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

An enterprise should not apply AS 16 to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis over a short period of time, since such inventories are not qualifying assets.

16.3 Qualifying Asset

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

Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

16.4 Substantial Period

The issue as to what constitutes 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 facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale should be considered.

Depending on the circumstances, any of the following may be qualifying assets.

- inventories that take a substantial amount of time to bring them to a saleable condition For example, liquor is often required to be kept in store for more than twelve months for maturing;
- investments properties;
- manufacturing plants; and
- power generation facilities.

The following are not qualifying assets:

- assets that are ready for their intended use or sale when acquired; and
- inventories that are rountinely manufactured, or otherwise produced in large quantities on a repetetitive basis, over a short period or time.

16.5 Borrowing Costs Eligible for Capitalisation

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

16.6 Exchange Differences on Foreign Currency Borrowings

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, 'The Effect of Changes in Foreign Exchange Rates'. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

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'.

16.7 Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

16.8 Commencement of Capitalisation

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following these conditions are satisfied:

a. *Expenditure for the acquisition, construction or production of a qualifying asset is being incurred:* Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

b. *Borrowing costs are being incurred*.

c. *Activities that are necessary to prepare the asset for its intended use or sale are in progress:* The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place.

16.9 Suspension of Capitalisation

Capitalisation of borrowing costs should generally continue as long as the three conditions listed above are met. If, however, the enterprise suspends activities related to development for an extended period, capitalisation of borrowing costs should also cease unit such time as activities are resumed.

However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

16.10 Cessation of Capitalisation

Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

16.11 Disclosure

The financial statements should disclose:

a. The accounting policy adopted for borrowing costs; and

b. The amount of borrowing costs capitalised during the period.

16.12 Illustrations

Illustration 1

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

Calculate the amount of borrowing to be capitalized.

Solution

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

Particulars	*Amount*
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	1,00,000
	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 = 4,30,000/7,30,000x1,05,000 = ₹ 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 = 18X 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		$52.20\times\frac{116}{580}=10.44$
		41.76	10.44

* 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	7,00,000	10,000	13,27,210	Note 4
	13,00,000	27,210	13,27,210	

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.

Reference: The students are advised to refer the full text of AS 16 “Borrowing Costs” (issued 2000).

UNIT 17 : AS 17: SEGMENT REPORTING

17.1 Introduction

This Standard came into effect in respect of accounting periods commencing on or after 1.4.2001 and is mandatory in nature, from that date, in respect of the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

This standard establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The information is expected to help users of financial statements, to better understand the performance and assess the risks and returns of the enterprise and make more informed judgements about the enterprise as a whole. The standard is more relevant for assessing risks and returns of a diversified or multilocational enterprise which may not be determinable from the aggregated data.

17.2 Objective

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. The objective of this Statement is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

(a) Better understand the performance of the enterprise;

(b) Better assess the risks and returns of the enterprise; and

(c) Make more informed judgements about the enterprise as a whole.

17.3 Scope

An enterprise should comply with the requirements of this Statement fully and not selectively. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Statement to any financial statement items should construed to be the relevant item as appearing in the consolidated financial statements.

17.4 Definition of the terms used in the Accounting Standard

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

a. The nature of the products or services.

b. The nature of the production processes.

c. The type or class of customers for the products or services;.

d. The methods used to distribute the products or provide the services and

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

A geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

a. Similarity of economic and political conditions.

b. Relationships between operations in different geographical areas.

c. Proximity of operations.

d. Special risks associated with operations in a particular area.

e. Exchange control regulations and

f. The underlying currency risks.

A single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.

The risks and returns of an enterprise are influenced both by the geographical location of its operations and also by the location of its customers. The definition allows geographical segments to be based on either:

a. The location of production or service facilities and other assets of an enterprise; or

b. The location of its customers.

A reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Statement.

The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

Segment revenue is the aggregate of

(i) The portion of enterprise revenue that is directly attributable to a segment,

(ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and

(iii) Revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

a. Extraordinary items as defined in AS 5.

b. Interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

c. Gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Segment expense is the aggregate of

(i) The expense resulting from the operating activities of a segment that is directly attributable to the segment, and

(ii) The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment,

(iii) Including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

a. Extraordinary items as defined in AS 5.

b. Interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature.

c. Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

d. Income tax expense; and

e. General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include:

- income tax assets;
- assets used for general enterprise or head-office purposes.

Segment assets are determined after deducting related allowances/provisions that are reported as direct offsets in the balance sheet of the enterprise.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Liabilities that relate jointly to two or more segment should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

Examples of segment liabilities include trade and other payables, accrued liabilities, customer advances, product warranty provisions, and other claims relating to the provision of goods and services.

Segment liabilities do not include:

- income tax liabilities;
- borrowings and other liabilities that are incurred for financing rather than operating purposes.

17.5 Treatment of Interest for determining Segment Expense

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories as per paragraph below.

In case interest is included as a part of the cost of inventories where it is so required as per AS 16, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest should be disclosed by way of a note to the segment result.

17.6 Allocation

An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segments.

In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Statement. Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

17.7 Primary and Secondary Segment Reporting Formats

The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments.Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided paragraphs below:

a. If risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a 'matrix approach', then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting forma; and

b. If internal organisational and management structure of an enterprise are based neither on individual products or services or groups of related products/services nor on geographical areas, it should be determined whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and accordingly, choose segments.

17.8 Matrix Presentation

A 'matrix presentation' both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis will often provide useful information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates. This Statement does not require, but does not prohibit, a 'matrix presentation'.

17.9 Business and Geographical Segments

Generally Business and Geographical segments are determined on the basis of internal financial reporting to the board of directors and the chief executive officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered for:

a. If one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions but others are not, paragraph below should be applied only to those internal segments that do not meet the definitions.

b. For those segments reported internally to the directors and management that do not satisfy the definitions, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions and

c. If such an internally reported lower-level segment meets the definition of business segment or geographical segment, the criteria for identifying reportable segments should be applied to that segment.

17.10 Identifying Reportable Segments (Quantitative Thresholds)

A business segment or geographical segment should be identified as a reportable segment if:

a. Its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or

b. Its segment result, whether profit or loss, is 10 per cent or more of –

    (i) The combined result of all segments in profit, or

    (ii) The combined result of all segments in loss,

    (iii) Whichever is greater in absolute amount; or

c. Its segment assets are 10 per cent or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment as per above paragraph, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

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

A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 percent thresholds.

If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

17.11 Segment Accounting Policies

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. This Statement does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and (b) the basis of measurement for this additional information is clearly described. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

17.12 Primary Reporting Format

An enterprise should disclose the following for each reportable segment:

a. Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;

b. Segment result;

c. Total carrying amount of segment assets;

d. Total amount of segment liabilities;

e. Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);

f. Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and

g. Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.

An enterprise is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the segment for the period. Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items. The disclosure, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the enterprise level to the segment level.

AS 3, recommends that an enterprise present a cash flow statement that separately reports cash flows from operating, investing and financing activities. Disclosure of information regarding operating, investing and financing cash flows of each reportable segment is relevant to understanding the enterprise's overall financial position, liquidity, and cash flows. Disclosure of segment cash flow is, therefore, encouraged, though not required. An enterprise that provides segment cash flow disclosures need not disclose depreciation and amortisation expense and non-cash expenses.

An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

17.13 Secondary Segment Information

If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:

a. Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue;

b. The total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments; and

c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments.

If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue or whose segment assets are 10 per cent or more of the total assets of all business segments:

a. Segment revenue from external customers;

b. The total carrying amount of segment assets; and

c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external customers for each customer-based geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in different geographical areas from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10 per cent or more of total enterprise amounts:

a. The total carrying amount of segment assets by geographical location of the assets.

b. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by location of the assets.

17.14 Disclosures

In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed in accordance with AS. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

Some changes in accounting policies may relate specifically to segment reporting.

Example could be:

- changes in identification of segments; and
- changes in the basis for allocating revenues and expenses to segments.

Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effects of the change, if reasonably determinable.

An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

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)
Forging Shop Division	
Sales to Bright Bar Division	*4,575*
Other Domestic Sales	*90*
Export Sales	*6,135*
	10,800

Bright Bar Division	
Sales to Fitting Division	*45*
Export Sales to Rwanda	*300*
	345
Fitting Division	
Export Sales to Maldives	*270*

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

Solution

Diversifiers Ltd.
Segmental Report

(₹’000)

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

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

Sales Revenue by Geographical Market

	Home Sales	*Export Sales (by forging 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'.

Reference: The students are advised to refer the full text of as 17 "segment reporting" (issued 2000).

UNIT 18 : AS 18: RELATED PARTY DISCLOSURES

18.1 Introduction

This Standard came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature. The standard prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company. Since the standard is more subjective, particularly with respect to identification of related parties [though provisions related to related party concept are given under sections 297 / 299 / 301 of the Companies Act, 1956 and section 40A (2)(b) of the Income Tax Act, 1961], obtaining corroborative evidence becomes very difficult for the auditors. Thus successful implementation of AS 18 is dependent upon how transparent the management is and how vigilant the auditors are.

18.2 Objective

The objective of this Statement is to establish requirements for disclosure of:

(a) Related party relationships and

(b) Transactions between a reporting enterprise and its related parties.

18.3 Scope

AS 18 should be applied:

- In reporting related party relationships and transactions between a reporting enterprise and its related parties.
- Only to the related party relationships described in (a) to (e) below.
- To the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

This Statement deals only with related party relationships described in (a) to (e) below:

a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).

b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.

d. Key management personnel and relatives of such personnel and

e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

18.4 Definitions of the Terms used in the Accounting Standard

In the context of this Statement, the following are deemed not to be related parties:

a. Two companies simply because they have a director in common, notwithstanding paragraph (d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings).

b. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and

c. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

   (i) Providers of finance.

   (ii) Trade unions.

   (iii) Public utilities.

   (iv) Government departments and government agencies including government sponsored bodies.

Related party disclosure requirements as laid down in this Statement do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Related party transaction: A transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Related party: Parties are consider 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.

Illustration

Identify the related parties in the following cases as per AS 18

A Ltd. holds 51% of B Ltd.

B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

Solution

A Ltd., B Ltd. & O Ltd. are related to each other. Z Ltd. & O Ltd. are related to each other by virtue of Associate relationship. However, neither A Ltd. nor B Ltd. is related to Z Ltd. and vice versa.

Control: (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

For the purpose of this Statement, an enterprise is considered to **control the composition** of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of that company/enterprise. An enterprise is deemed to have the power to appoint, if any of the following conditions is satisfied:

(a) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid or

(b) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise or

(c) The director/member is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

An enterprise/individual is considered to have a **substantial interest** in another enterprise if that enterprise or individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise.

An Associate: An enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

Significant influence: Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

It may be exercised in several ways, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information.

Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case, vice versa. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

Key management personnel: Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

A non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

The requirements of this standard should not be applied in respect of a non executive director even if he participates in the financial and/or operating policy decision of the enterprise, unless he falls in any of the other categories.

Relative: In relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

Joint Venture - a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

Joint Control – the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

Holding Company – a company having one or more subsidiaries.

Subsidiary - a company:

(a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half, in nominal value of its equity share capital; or

(b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

Fellow subsidiary – a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

18.5 The Related Party Issue

Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties.

The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties.

In view of the aforesaid, the resulting accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

As per the Guidance Note on 'Remuneration paid to Key Management Personnel - Whether a Related Party Transaction', remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

18.6 Disclosure

Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

This is to enable users of financial statements to form a view about the effects of related party relationships on the enterprise.

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

(i) The name of the transacting related party;

(ii) A description of the relationship between the parties;

(iii) A description of the nature of transactions;

(iv) Volume of the transactions either as an amount or as an appropriate proportion;

(v) Any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

(vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

(viii) Items of a similar nature may be disclosed in aggregate by type of related party.

18.7 Miscellaneous Illustrations

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.

Reference: The students are advised to refer the full text of AS 18 "Related Party Disclosures" (issued 2000).

UNIT 19 : AS 19 : LEASES

19.1 Introduction

This Standard came into effect in respect of all assets leased during accounting periods commencing on or after 1.4.2001 and is mandatory in nature. AS 19 prescribes the accounting and disclosure requirements for both finance leases and operating leases in the books of the lessor and lessee. The classification of leases adopted in this standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor and the lessee.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership.

An operating lease is a lease other than finance lease.

At the inception of the lease, assets under finance lease are capitalized in the books of lessee with corresponding liability for lease obligations as against the operating lease, wherein lease payments are recognized as an expense in profit and loss account on a systematic basis (i.e. straight line) over the lease term without capitalizing the asset. The lessor should recognise receivable at an amount equal to net investment in the lease in case of finance lease, whereas under operating lease, the lessor will present the leased asset under fixed assets in his balance sheet besides recognizing the lease income on a systematic basis (i.e. straight line) over the lease term. The person (lessor/lessee) presenting the leased asset in his balance sheet should also consider the additional requirements of AS 6 and AS 10.

19.2 Scope

This Statement is applied in accounting for all leases other than:

a. Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights and

b. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights and

c. Lease agreements to use lands.

AS 19 applies to contracts that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Examples include the supply of property, vehicles and computers.

On the other hand, this Statement does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

19.3 Definition of the Terms used under AS 19

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

An operating lease is a lease other than a finance lease.

A non-cancellable lease is a lease that is cancellable only:

a. Upon the occurrence of some remote contingency or

b. With the permission of the lessor or

c. If the lessee enters into a new lease for the same or an equivalent asset with the same lessor;

d. Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum lease payments are the payments over the lease term that the lessee is, or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

a. In the case of the lessee, any residual value guaranteed by or on behalf of the lessee or

b. In the case of the lessor, any residual value guaranteed to the lessor:

   (i) By or on behalf of the lessee or

   (ii) By an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

Mr. X took mine on lease from Mr. Y on the terms that he would pay ₹ 10,000 or ₹ 10 per ton extracted during the year, which ever is less. ₹ 10 per ton been contingent cannot be included in minimum lease payment calculation.

Economic life is either:

a. The period over which an asset is expected to be economically usable by one or more users;

b. The number of production or similar units expected to be obtained from the asset by one or more users.

Useful life of a leased asset is either:

a. The period over which the leased asset is expected to be used by the lessee or

b. The number of production or similar units expected to be obtained from the use of the asset by the lessee.

Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

Guaranteed residual value is:

a. In the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable) and

b. In the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

We can say that:

Residual Value of the Assets = Guaranteed Residual Value + Unguaranteed Residual Value

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Unearned finance income is the difference between:

a. The gross investment in the lease and

b. The present value of

   (i) The minimum lease payments under a finance lease from the standpoint of the lessor and

   (ii) Any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Net investment in the lease is the gross investment in the lease less unearned finance income.

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

a. The minimum lease payments under a finance lease from the standpoint of the lessor and

b. Any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices and market rates of interest).

19.4 Classification of Leases

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which individually or in combination would normally lead to a lease being classified as a finance lease are:

a. The lease transfers ownership of the asset to the lessee by the end of the lease term.

b. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

c. The lease term is for the major part of the economic life of the asset even if title is not transferred.

d. At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset or

e. The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Other indicators that, individually or in combination, could also lead to a lease being classified as a finance lease are:

a. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

b. Gains or losses from the fluctuation in the fair value of the residual fall to the lessee and

c. The lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease after inception, other than by renewing the lease, in a manner that would have resulted in a different classification, had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates or changes in circumstances, however, do not give rise to a new classification of a lease for accounting purposes.

19.5 Leases in the Financial Statements of Lessees

19.5.1 Finance Leases: (1) Both the leased asset and the related lease obligation (liability) should be recorded in the balance sheet.

At the inception of a finance lease,

Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

In the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

Initial direct costs are often incurred in connection with specific leasing activities, eg in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the finance lease to the extent that they can be directly attributed to the activities performed by the lessee for a finance lease.

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability.

The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

19.5.2 Operating Leases : Rentals payable under an operating lease should be charged as an expense in the statement of profit and loss on a straight-line basis over the lease term, even if the payments are not made on that basis, unless another systematic basis is more representative of the time pattern of the user's benefit. For example, where the rental payments for an asset are based on the actual usage of that asset, or are revised periodically to reflect the efficiency of the asset or current market rates, the rentals actually payable may be an appropriate measure.

19.5.3 Disclosure Requirements: Lessees are required to make the following disclosures for Finance leases:

- Assets acquired under finance lease as segregated from assets owned;
- For each class of assets, the net carrying amount at the balance sheet date;
- A reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value; (SMC are exempt from this disclosure requirement)
- The total of future minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
  - Not later than one year;
  - Later than one year and not later than five years; and
  - Later than five years;

(SMCs are exempt from this disclosure requirement)

- Contigent rents recognized as an expense in the period;
- The total of future minimum sublease payments expected to be received under non-cancellable sub-leases at the balance sheet date (SMCs are exempt from this disclosure requirement); and
- A general description of the lessee's material leasing arrangements including, but not limited to, the following:
  - The basis on which contigent rents are determined;
  - The existence and terms of renewal or purchase options and escalation clauses; and
  - Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

(SMCs are exempt from this disclosure requirement)

Note that in addition to the above the disclosure requirements of AS 6 and AS 10 apply equally to assets held under finance leases.

Operating leases:

a. The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

   (i) Not later than one year;

   (ii) Later than one year and not later than five years;

   (iii) Later than five years;

b. The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

c. Lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

d. Sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

e. A general description of the lessee's significant leasing arrangements including, but not limited to, the following:

   (i) The basis on which contingent rent payments are determined;

   (ii) The existence and terms of renewal or purchase options and escalation clauses; and

   (iii) Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

19.6 Leases in the Financial Statements of Lessors

19.6.1 Finance Lease: The lessor should recognise assets given under a finance lease in its balance sheet as a receivable and sales in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. The transaction is recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded is the present value so computed. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

a. The profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts;

b. The finance income over the lease term.

Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income.Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged and balance will be adjusted with the finance income over the lease term.

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

19.6.2 **Disclosure :** The lessor should make the following disclosures for finance leases:

a. A reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
   (i) Not later than one year;
   (ii) Later than one year and not later than five years;
   (iii) Later than five years;
b. Unearned finance income;
c. The unguaranteed residual values accruing to the benefit of the lessor;
d. The accumulated provision for uncollectible minimum lease payments receivable;
e. Contingent rents recognised in the statement of profit and loss for the period;
f. A general description of the significant leasing arrangements of the lessor; and
g. Accounting policy adopted in respect of initial direct costs.

Illustration 1 (finance lease)

'A' leased a machine from 'B' on the following terms:

a. The ownership of the machine will be transferred to 'A' on expiry of the lease period at ₹8,900.
b. Installation cost of the machine ₹5,000.
c. The cost of the machine is ₹1,09,240.
d. Lease agreement is signed for 5 years.
e. Minimum Lease Payment is ₹28,000 p.a.
f. First installment is Payable on 01.04.2012.
g. Depreciation is charged @ 25% p.a. on WDV.

You are required to show the complete chart of principle amount and implicit rate of interest for 5 years and also the journal entries in the books of 'A and B' for the period 01.04.2012 to 31.03.2017.

Solution

First calculate the implicit rate of return, i.e. the rate of Present Value at which the PV of Minimum Lease Payment equals to Market Price of the Assets on the date of lease agreement.

Lease Payment	*Present Value Factor @ 12%*	*Present Value of Lease Payment*	*Present Value Factor @ 14%*	*Present Value of Lease Payment*
28,000	1	28,000	1	28,000
28,000	0.893	25,000	0.877	24,561
28,000	0.797	22,321	0.769	21,545
28,000	0.712	19,930	0.675	18,899
28,000	0.636	17,795	0.592	16,578
8,900	0.567	5,050	0.519	4,622
		118,096		114,206

Installment	*Opening Balance*	*Interest Amount*	*Principle Amount*	*Closing Balance*
1	114,240	-	28,000	86,240
2	86,240	12,074	15,926	70,314
3	70,314	9,844	18,156	52,158
4	52,158	7,302	20,698	31,460
5	31,460	4,404	23,596	7,864
	7,864	1,036	7,864	(0)

Journal Entries:

In the Books of Mr. A				*In the Books of Mr. B*		
Date	*Particulars*	*Dr.*	*Cr.*	*Particulars*	*Dr.*	*Cr.*
Purchase of Machine on Lease:						
2012						
01-April	Machine on Lease A/c Dr.	114,240		Mr. A A/c Dr.	109,240	
	To Mr. B A/c		109,240	To Lease Sales A/c		109,240
	To Bank A/c		5,000			
Payment of First Installment:						
	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the First Year @ 14% p.a.:						
2013						
31-March	Interest A/c Dr.	12,074		Mr. A A/c Dr.	12,074	

	To Mr. B A/c		12,074	To Interest A/c		12,074
Charging Depreciation:						
	Depreciation A/c Dr.	28,560				
	To Machine A/c		28,560			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	40,634		Interest A/c Dr.	12,074	
	To Interest A/c		12,074	To Profit & Loss A/c		12,074
	To Depreciation A/c		28,560			
Payment of Second Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Second Year @ 14% p.a.:						
2014						
31-March	Interest A/c Dr.	9,844		Mr. A A/c Dr.	9,844	
	To Mr. B A/c		9,844	To Interest A/c		9,844
Charging Depreciation:						
	Depreciation A/c Dr.	21,420				
	To Machine A/c		21,420			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	31,264		Interest A/c Dr.	9,844	
	To Interest A/c		9,844	To Profit & Loss A/c		9,844
	To Depreciation A/c		21,420			
Payment of Third Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Third Year @ 14% p.a.:						
2015						
31-March	Interest A/c Dr.	7,302		Mr. A A/c Dr.	7,302	
	To Mr. B A/c		7,302	To Interest A/c		7,302
Charging Depreciation:						
	Depreciation A/c Dr.	16,065				
	To Machine A/c		16,065			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	23,367		Interest A/c Dr.	7,302	
	To Interest A/c		7,302	To Profit & Loss A/c		7,302

	To Depreciation A/c		16,065			
Payment of Fourth Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Fourth Year @ 14% p.a.:						
2016						
31-March	Interest A/c Dr.	4,404		Mr. A A/c Dr.	4,404	
	To Mr. B A/c		4,404	To Interest A/c		4,404
Charging Depreciation:						
	Depreciation A/c Dr.	12,049				
	To Machine A/c		12,049			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	16,453		Interest A/c Dr.	4,404	
	To Interest A/c		4,404	To Profit & Loss A/c		4,404
	To Depreciation A/c		12,049			
Payment of Fifth Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Last Year @ 14% p.a.:						
2017						
31-March	Interest A/c Dr.	1,036		Mr. A A/c Dr.	1,036	
	To Mr. B A/c		1,036	To Interest A/c		1,036
Charging Depreciation:						
	Depreciation A/c Dr.	9,037				
	To Machine A/c		9,037			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	10,073		Interest A/c Dr.	1,036	
	To Interest A/c		1,036	To Profit & Loss A/c		1,036
	To Depreciation A/c		9,037			
Purchase of Asset on expiry of Lease Term:						
	Mr. B A/c Dr.	8,900		Bank A/c Dr.	8,900	
	To Bank A/c		8,900	To Mr. A A/c		8,900

19.6.3 Operating Leases: The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

Lease income should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Initial direct costs incurred are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.For charging depreciation and impairment of assets, relevant Accounting Standards should be followed.

19.6.4 Disclosures

a. For each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
   (i) The depreciation recognised in the statement of profit and loss for the period;
   (ii) Impairment losses recognised in the statement of profit and loss for the period;
   (iii) Impairment losses reversed in the statement of profit and loss for the period;

b. The future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
   (i) Not later than one year;
   (ii) Later than one year and not later than five years;
   (iii) Later than five years;

c. Total contingent rents recognised as income in the statement of profit and loss for the period;

d. A general description of the lessor's significant leasing arrangements; and

e. Accounting policy adopted in respect of initial direct costs.

Illustration 2 (Operating lease)

Geeta purchased a computer for ₹ 44,000 and leased out it to Sita for four years on leases basis, after the lease period, value of the computer was estimated to be ₹ 3,000; which she realised after selling it in the second hand market. Lease amount payable at the beginning of each year is ₹ 22,000; ₹ 13,640; ₹ 6,820 & ₹ 3,410. Depreciation was charged @ 40% p.a. You are required to pass the necessary journal entries in the books of both Geeta and Sita.

Solution

In the Books of Geeta				*In the Books of Sita*		
Date	*Particulars*	*Dr.*	*Cr.*	*Particulars*	*Dr.*	*Cr.*
<u>Purchase of computers:</u>						
1st	Computer A/c. Dr.	44,000				
	To Bank A/c		44,000			
<u>Payment of first year's lease:</u>						
	Bank A/c. Dr.	22,000		Lease Rent Paid A/c. Dr.	22,000	
	To Lease Rent A/c.		22,000	To Bank A/c.		22,000

Depreciation for first year:						
	Depreciation A/c Dr.	17,600				
	To Machine A/c		17,600			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	17,600		Profit & Loss A/c. Dr.	22,000	
	To Depreciation A/c		17,600	To Lease Rent Paid A/c.		22,000
	Lease Rent A/c. Dr.	22,000				
	To Profit & Loss A/c.		22,000			
Payment of second year's lease:						
2nd	Bank A/c. Dr.	13,640		Lease Rent Paid A/c. Dr.	13,640	
	To Lease Rent A/c.		13,640	To Bank A/c.		13,640
Depreciation for second year:						
	Depreciation A/c Dr.	10,560				
	To Machine A/c		10,560			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	10,560		Profit & Loss A/c. Dr.	13,640	
	To Depreciation A/c		10,560	To Lease Rent Paid A/c.		13,640
	Lease Rent A/c. Dr.	13,640				
	To Profit & Loss A/c.		13,640			
Payment of third year's lease:						
3rd	Bank A/c. Dr.	6,820		Lease Rent Paid A/c. Dr.	6,820	
	To Lease Rent A/c.		6,820	To Bank A/c.		6,820
Depreciation for third year:						
	Depreciation A/c Dr.	6,336				
	To Machine A/c		6,336			
Transfer to profit & lossaccount:						
	Profit & Loss A/c Dr.	6,336		Profit & Loss A/c. Dr.	6,820	
	To Depreciation A/c		6,336	To Lease Rent Paid A/c.		6,820
	Lease Rent A/c. Dr.	6,820				
	To Profit & Loss A/c.		6,820			
Payment of fourth year's lease:						
4th	Bank A/c. Dr.	3,410		Lease Rent Paid A/c.Dr.	3,410	
	To Lease Rent A/c.		3,410	To Bank A/c.		3,410

Depreciation for fourth year:					
Depreciation A/c Dr.	3,802				
To Machine A/c		3,802			
Transfer to profit & loss account:					
Profit & Loss A/c Dr.	3,802		Profit & Loss A/c. Dr.	3,410	
To Depreciation A/c		3,802	To Lease Rent Paid A/c.		3,410
Lease Rent A/c. Dr.	3,410				
To Profit & Loss A/c.		3,410			
Sale of lease asset:					
Bank Account Dr.	3,000				
Loss on Sale A/c. Dr.	2,702				
To Computer A/c.		5,702			

19.7 Sale and Leaseback Transactions

A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

Illustration 3

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

19.8 Miscellaneous Illustrations

Illustration 4

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

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

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.

Gross investment = Minimum lease payments + Unguaranteed residual value
=(Total lease rent + Guaranteed residual value) + Unguaranteed residual value
= [(₹ 5,00,000 × 5 years) + ₹ 1,00,000] + ₹ 1,00,000
= ₹ 27,00,000

(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 (guaranteed residual value)	.4972	49,720	
			17,25,820	(i)
	1,00,000 (unguaranteed residual value)	.4972	49,720	(ii)
		(i) + (ii)	17,75,540	(b)

Unearned Finance Income = (a) – (b)
= ₹ 27,00,000 – ₹ 17,75,540 = ₹ 9,24,460

Journal Entries in the books of B Ltd.

		₹	₹
At the inception of lease			
Machinery account	Dr.	17,25,820*	
To A Ltd.'s account			17,25,820*
(Being lease of machinery recorded at present value of MLP)			
At the end of the first year of lease			
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 per para 11 of AS 19, the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of ₹ 20,00,000 is more than the present value amounting ₹ 17,25,820, the machinery has been recorded at ₹ 17,25,820 in the books of B Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

Working Note:

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

Year	*Outstanding liability (opening balance)* ₹	*Lease rent* ₹	*Finance charge* ₹	*Reduction in outstanding liability* ₹	*Outstanding liability (closing balance)* ₹
1	17,25,820	5,00,000	2,58,873	2,41,127	14,84,693
2	14,84,693	5,00,000	2,22,704	2,77,296	12,07,397
3	12,07,397	5,00,000	1,81,110	3,18,890	8,88,507
4	8,88,507	5,00,000	1,33,276	3,66,724	5,21,783
5	5,21,783	5,00,000	78,267	5,21,783	1,00,050*
			8,74,230	17,25,820	

*The difference between this figure and guaranteed residual value (₹ 1,00,000) is due to approximation in computing the interest rate implicit in the lease.

Illustration 5

Global Ltd. has initiated a lease for three years in respect of an equipment costing ₹ 1,50,000 with expected useful life of 4 years. The asset would revert to Global Limited under the lease agreement. The other information available in respect of lease agreement is:

(i) The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at ₹ 20,000.

(ii) The implicit rate of interest is 10%.

(iii) The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hands of Global Ltd.

(i) The annual lease payment.

(ii) The unearned finance income.

(iii) The segregation of finance income, and also,

(iv) Show how necessary items will appear in its profit and loss account and balance sheet for the various years.

Solution

(a) (i) Calculation of Annual Lease Payment*

	₹
Cost of the equipment	1,50,000
Unguaranteed Residual Value	20,000
PV of residual value for 3 years @ 10% (₹ 20,000 x 0.751)	15,020

* Annual lease payments are considered to be made at the end of each accounting year.

Fair value to be recovered from Lease Payment (₹ 1,50,000 – ₹ 15,020)	1,34,980
PV Factor for 3 years @ 10%	2.487
Annual Lease Payment (₹ 1,34,980 / PV Factor for 3 years @ 10% i.e. 2.487)	54,275

(ii) Unearned Financial Income

Total lease payments [₹ 54,275 x 3]	1,62,825
Add: Residual value	20,000
Gross Investments	1,82,825
Less: Present value of Investments (₹ 1,34,980 + ₹ 15,020)	1,50,000
Unearned Financial Income	32,825

(iii) Segregation of Finance Income

Year	*Lease Rentals* ₹	*Finance Charges @ 10% on outstanding amount of the year* ₹	*Repayment* ₹	*Outstanding Amount* ₹
0	-	-	-	1,50,000
I	54,275	15,000	39,275	1,10,725
II	54,275	11,073	43,202	67,523
III	74,275**	6,752	67,523	--
	1,82,825	32,825	1,50,000	

(iv) Profit and Loss Account (Relevant Extracts)

Credit side		₹
I Year	By Finance Income	15,000
II year	By Finance Income	11,073
III year	By Finance Income	6,752

Balance Sheet (Relevant Extracts)

Assets side	₹	₹
I year Lease Receivable	1,50,000	
Less: Amount Received	39,275	1,10,725
II year Lease Receivable	1,10,725	
Less: Received	(43,202)	67,523
III year :Lease Amount Receivable	67,523	
Less: Amount received	(47,523)	
Residual value	(20,000)	NIL

** ₹ 74,275 includes unguaranteed residual value of equipment amounting ₹ 20,000.

Notes to Balance Sheet

Year 1	₹
Minimum Lease Payments (54,275 + 54,275)	1,08,550
Residual Value	20,000
	1,28,550
Unearned Finance Income(11,073+ 6,752)	(17,825)
Lease Receivables	1,10,725
Classification:	
Not later than 1 year	43,202
Later than 1 year but not more than 5 years	67,523
Total	1,10,725
Year II:	
Minimum Lease Payments	54,275
Residual Value (Estimated)	20,000
	74,275
Unearned Finance Income	(6,752)
Lease Receivables (not later than 1 year)	67,523
III Year:	
Lease Receivables (including residual value)	67,523
Amount Received	67,523
	NIL

Reference: The students are advised to refer the full text of AS 19 “Leases” (issued 2001).

UNIT 20 : AS 20: EARNINGS PER SHARE

20.1 Introduction

AS 20 comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature. The objective of this standard is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement.

Every company, which is required to give information under Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

20.2 Definition of the terms used in the Accounting Standard

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

For this purpose, a financial asset is any asset that is

a. Cash;

b. A contractual right to receive cash or another financial asset from another enterprise;

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

d. An equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

a. Debt instruments or preference shares, that are convertible into equity shares;

b. Share warrants;

c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

20.3 Basic Earnings per Share

Basic earnings per share is calculated as

$$\frac{\text{Net profit (loss) attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the period}}$$

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS – 5 requires or permits otherwise.

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

The number of shares used in the denominator for basic EPS should be the weighted average number of equity shares outstanding during the period.

The weighted average number of equity shares outstanding during the period is the number of shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by a time-weighting factor.

The calculation is based on all shares outstanding during the period. Whether or not a particular class or tranche of shares ranked for dividends in respect of the period is irrelevant (except in the case of partly paid shares).

The time-weighting factor is:

$$\frac{\text{Numbers of days the shares are outstanding}}{\text{Number of days in the period}}$$

Although the Standard defines the time-weighting factor as being determined on a daily basis, it acknowledges that a reasonable approximation of the weighted average is adequate in many circumstances.

Depending on the relative size of share movements, this might, for example, be based on the number of months for which shares were outstanding.

Illustration 1

Date	*Particulars*	*Purchased*	*Sold*	*Balance*
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 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

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

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

a. Equity shares issued in exchange for cash are included when cash is receivable;

b. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

c. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

d. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

a. A bonus issue;

b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

c. A share split; and

d. A reverse share split (consolidation of 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 2

Date	*Particulars*	*No. of Share Face Value*	*Paid up Value*	
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 x 12/12) + (300 x 2/12) = 1,850 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

Net profit for the year 2011	*₹ 18,00,000*
Net profit for the year 2012	*₹ 60,00,000*
No. of equity shares outstanding until 30th September 2012	*20,00,000*

Bonus issue 1st October 2012 was 2 equity shares for each equity share outstanding at 30th September, 2012

Calculate Basic Earnings Per Share.

Solution

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

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

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

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

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.

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

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

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

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

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

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

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 x 1.05 x 2/12) + (6,00,000 x 10/12) = 5,87,500 shares

EPS = 15,00,000/5,87,500 = ₹ 2.55

20.4 Diluted Earnings Per Share

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

a. The net profit for the period attributable to equity shares is:

   i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

   ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

   iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

b. The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

In order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Illustration 5

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

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

20.5 Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

20.6 Presentation

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

20.7 Disclosure

An enterprise should disclose the following:

a. Where the statement of profit and loss includes extraordinary items (as defined is AS 5), basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense);

b. The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

c. The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

d. The nominal value of shares along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

Illustration 6

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

Compute Basic and Diluted Earnings Per Share.

Solution

Computation of earnings per share

	Earnings ₹	*Shares*	*Earnings/ Share* ₹
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 x 15.00)/20.00		(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

Illustration 7

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

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

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

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.

Illustration 8

From the Books of Bharati Ltd., following informations are available as on 1.4.2010 and 1.4.2011:

(1)	*Equity Shares of ₹ 10 each*	*1,00,000*
(2)	*Partly paid Equity Shares of ₹ 10 each ₹ 5 paid*	*1,00,000*
(3)	*Options outstanding at an exercise price of ₹ 60 for one equity share ₹ 10 each. Average Fair Value of equity share during both years ₹ 75*	*10,000*
(4)	*10% convertible preference shares of ₹ 100 each. Conversion ratio 2 equity shares for each preference share*	*80,000*
(5)	*12% convertible debentures of ₹ 100. Conversion ratio 4 equity shares for each debenture*	*10,000*
(6)	*10% dividend tax is payable for the years ending 31.3.2012 and 31.3.2011.*	
(7)	*On 1.10.2011 the partly paid shares were fully paid up*	
(8)	*On 1.1.2012 the company issued 1 bonus share for 8 shares held on that date.*	

Net profit attributable to the equity shareholders for the years ending 31.3.2012 and 31.3.2011 were ₹ 10,00,000. Assume Tax rate at 30% for both the years.

Calculate :

(i) Earnings per share for years ending 31.3.2012 and 31.3.2011.

(ii) Diluted earnings per share for years ending 31.3.2012 and 31.3.2011.

(iii) Adjusted earnings per share and diluted EPS for the year ending 31.3.2011, assuming the same information for previous year, also assume that partly paid shares are eligible for proportionate dividend only.

Solution

(i) Earnings per share

	Year ended 31.3.2012	*Year ended 31.3.2011*
Net profit attributable to equity shareholders	₹ 10,00,000	₹ 10,00,000
Weighted average number of equity shares [(W.N. 1) – without considering bonus issue for the year ended 31.3.2012]	2,00,000	1,50,000
Earning per share	₹ 5	₹ 6.667

(ii) Diluted earnings per share

Options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (as per W.N. 2).

	Year ended 31.3.2012			*Year ended 31.3.2011*	
	Net profit attributable to equity shareholders ₹	*No. of equity shares*	*Net Profit attributable per share ₹*	No. of equity shares *(without considering bonus issue)*	*Net Profit attributable per share ₹*
As reported (for years ended 31.3.2012 and 31.3.2011)	10,00,000	2,00,000	5	1,50,000	6.667
Options		2,000		2,000	
	10,00,000	2,02,000	4.95 Dilutive	1,52,000	6.579 Dilutive
12% Convertible debentures	84,000	40,000		40,000	
	10,84,000	2,42,000	4.48 Dilutive	1,92,000	5.646 Dilutive
10% Convertible Preference Shares	8,80,000	1,60,000		1,60,000	
	19,64,000	4,02,000	4.886 Anti-Dilutive	3,52,000	5.58 Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (₹ 4.48 to ₹ 4.886), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share for the year ended 31.3.2012. Therefore, diluted earnings per share for the year ended 31st March, 2012 is ₹ 4.48.

For the year ended 31st March, 2011, Options, 12% Convertible debentures and Convertible preference shares will be considered dilutive and diluted earnings per share will be taken as ₹ 5.58.

	Year ended 31.3.2012	*Year ended 31.3.2011*
Diluted earnings per Share	4.48	5.58

(iii) Adjusted earnings per share and diluted earnings per share for the year ending 31.3.2011.

Net profit attributable to equity shareholders	₹ 10,00,000
Weighted average number of equity shares [(W.N. 1) – considering bonus issue]	1,75,000
Adjusted earnings per share	₹ 5.714

Calculation of adjusted diluted earnings per share

	Net profit attributable to equity shareholders ₹	*No. of equity shares (after considering bonus issue)*	*Net profit attributable per share* ₹
As reported	10,00,000	1,75,000	5.714
Options	________	2,000	
	10,00,000	1,77,000	5.65 Dilutive
12% Convertible Debentures	84,000	40,000	
	10,84,000	2,17,000	4.995 Dilutive
10% Convertible Preference Shares	8,80,000	1,60,000	
	19,64,000	3,77,000	5.21 Anti –Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from ₹ 4.995 to ₹ 5.21), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, adjusted diluted earnings per share for year ended 31.3.2011 is ₹ 4.995.

Adjusted diluted earnings per share ₹ 4.995

Working Notes:

1. Weighted average number of equity shares

		31.3.2012 No. of Shares	*31.3.2011 No. of Shares*
(a)	Fully paid equity shares	1,00,000	1,00,000
(b)	Partly paid equity shares*		50,000
	Partly paid equity shares	25,000	
	Fully paid equity shares	50,000	
	(Partly paid shares converted into fully paid up on 1.10.2011)		
(c)	Bonus Shares**	25,000	______
	Weighted average number of equity shares	2,00,000	1,50,000
	(without considering bonus issue for year ended 31.3.2011)		
	Bonus Shares		25,000
	Weighted average number of equity shares		1,75,000
	(after considering bonus issue for year ended 31.3.2011)		

*Since partly paid equity shares are entitled to participate in dividend to the extent of amount paid, 1,00,000 equity shares of ₹ 10 each, ₹ 5 paid up will be considered as 50,000 equity shares for the year ended 31st March, 2011.

On 1st October, 2011 the partly paid shares were converted into fully paid up. Thus, the weighted average equity shares (for six months ended 30th September, 2011) will be calculated as

$50{,}000 \times \frac{6}{12} = 25{,}000$ shares

Weighted average shares (for six months ended 31st March, 2012) will be calculated as

$1{,}00{,}000 \times \frac{6}{12} = 50{,}000$ shares

**Total number of fully paid shares on 1st January, 2012

Fully paid shares on 1st April, 2011	1,00,000
Partly paid shares being made fully paid up on 1st October, 2011	1,00,000
	2,00,000

The company issued 1 bonus share for 8 shares held on 1st January, 2012.

Thus, 2,00,000/8 = 25,000 bonus shares will be issued.

Bonus is an issue without consideration, thus it will be treated as if it had occured prior to the beginning of 1st April, 2010, the earliest period reported.

2. Increase in earnings attributable to equity shareholders on conversion of potential equity shares

	Increase in earnings *(1)*	*Increase in number of equity shares* *(2)*	*Earnings per incremental share* *(3) = (1) ÷ (2)*
	₹		₹
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration [10,000 × (75 – 60)/75]		2,000	Nil
Convertible Preference Shares			
Increase in net profit attributable to equity shareholders as adjusted by attributable dividend tax [(₹ 10 × 80,000) + 10% (₹ 10 × 80,000)]	8,80,000		
No. of incremental shares (2 × 80,000)		1,60,000	5.50
12% Convertible Debentures			
Increase in net profit [(₹ 10,00,000 × 0.12 × (1 – 0.30)]	84,000		
No. of incremental shares (10,000 × 4)		40,000	2.10

Illustration 9

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

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

Solution

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

	Year 2010 ₹	*Year 2011* ₹
EPS for the year 2010 as originally reported $= \dfrac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$ = (₹ 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 $\dfrac{₹\ 30,00,000}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$ $\dfrac{₹\ 30,00,000}{11,97,500 \text{ shares}}$		2.51 (approx.)

Working Notes:

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

* Refer working note 2.

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

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

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

2. Computation of adjustment factor

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

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

Note: An Exposure Draft of Limited Revision on AS 20 has recently been issued by the ICAI to address the conceptual issues in arriving at earnings for computation of EPS. It is pertinent to note that this Limited Revision is still in the form of exposure draft and will come into effect as and when it will be notified by the Government.

Reference: The students are advised to refer the full text of AS 20 "Earnings per Share" (issued 2001).

UNIT 21 : AS 21: CONSOLIDATED FINANCIAL STATEMENTS

21.1 Introduction

This AS comes into effect in respect of accounting periods commencing on or after 1-4-2001. AS 21 lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (holding company) to provide financial information about the economic activities of the group as a single economic entity. A parent which presents consolidated financial statements should present their statements in accordance with this standard but in its separate financial statements, investments in subsidiaries should be accounted as per AS 13.

21.2 Objective

The objective of this Statement is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated Financial Statement is prepared by the holding/parent company to provide financial information regarding the economic resources controlled by its group and results achieved with these resources. This consolidated financial statement is prepared by the parent company in addition to the financial statement prepared by the parent company for only it's own affairs. Hence parent company prepares two financial statements, one for only its own affairs and one for taking the whole group as one unit in the form of consolidated financial statement. Consolidated financial statements usually comprise the following:

- Consolidated Balance Sheet
- Consolidated Profit & Loss Statement
- Notes to Accounts, other statements and explanatory material
- Consolidated Cash Flow Statement, if parent company presents its own cash flow statement.

While preparing the consolidated financial statement, all other ASs and Accounting Policies will be applicable as they are applied in parent company's own financial statement.

21.3 Scope

This statement applies to the financial statement prepared by the parent company including the financial information of all its subsidiaries taken as one single financial unit. One should refer to this AS for the investment in subsidiaries to be disclosed in the financial statement prepared by the parent company separately. But this statement does not deal with:

a. Methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (AS 14).

b. Accounting for investments in associates (AS 13) and

c. Accounting for investments in joint ventures (AS 13).

21.4 Definitions of the Terms used in the Accounting Standard

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities. **Minority interest** is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary (ies), by the parent.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

21.5 Circumstances under which Preparation of Consolidated Financial Statements are Prepared

AS 21 should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

AS 21 does not mandate which enterprises are required to prepare consolidated financial statements – but specifies the rules to be followed where such financial statements are prepared.

Consolidated Financial Statement will be prepared by the parent company for all the companies that are controlled by the parent company either directly or indirectly, situated in India or abroad except in the following cases:

a. Control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future.

   In view of the above, merely holding all the shares as 'inventory-in-trade', is not sufficient to be considered as temporary control. It is only when all the shares held as 'inventory-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, that control would be considered to be temporary within the meaning of the paragraph.

   The term 'Near Future' is a period not exceeding 12 months in normal case. For the above purpose, one should note the intention at the time of making the investment, if the intention is to continue with the equity for longer period then even though it is disposed off within 12 months, investee company would still be considered as subsidiary. On the other hand, if intention at the time of purchase is dispose it in near future, but the parent company was not able to dispose of the shares even after the end of 12 months, shares will continue to be considered as inventory.

b. Or subsidiary company operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the parent.

When the parent company has some restrictions on bringing the resources of the subsidiary company to its main resources then consolidated financial statement is not required, as the control is not resulting in extra cash flow to parent company other than as mere investment in share of any other company i.e. dividend, bonus shares.

Therefore, in both the above cases, investment of parent company in the share of its subsidiary company is treated as investment according to AS 13.

Exclusion of subsidiary company will be only for any of the above reasons but a company cannot be treated as outside the group just because the main business of the subsidiary company is not in line with the business of parent company.

21.6 Subsidiaries with Dissimilar Activities

AS 21 states that it is inappropriate to exclude subsidiaries from consolidation on the ground that their business activities are substantially different from those of the parent and/or the rest of the group. As long as the parent retains control over such subsidiaries, they are required to be consolidated. Information regarding the different nature of the activities of a subsidiary can be appropriately disclosed by listed companies in accordance with AS 17 Segment Reporting.

21.7 Loss of Control

When a parent loses control, the investee no longer meets the definition of subsidiary, and so it is no longer consolidated.

Where a parent loses control over a subsidiary, the investment will be accounted for under AS 13 Accounting for Investments from the date of loss of control, provided that the investor does not retain significant influence (in which case the investment will be accounted for under AS 23)

21.8 Existence of Control

Control Exists when Parent Company has either:

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

   For example, A Ltd. holds 75% shares in B Ltd., then B Ltd. is subsidiary of A Ltd., in other words A Ltd. is the parent company.

   If A Ltd. is holding 25% shares in C Ltd., then there is no holding-subsidiary relationship between them. But if along with A Ltd., B Ltd. also holds 30% shares in C Ltd., then A Ltd. holding in C Ltd. is 55%, though indirectly, and A Ltd. is parent company of both B Ltd. and C Ltd.

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

Point to be noted here is that, the control over composition of board or governing body is for economic benefit. If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

An enterprise is considered to control the composition of the board of directors or governing body of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body.

An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

(i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or

(ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or

(iii) The director/member is nominated by that enterprise or a subsidiary thereof.

If A Ltd. is proved to be a subsidiary company of B Ltd. by virtue of point (a) and also a subsidiary of C Ltd. as per point (b), then the problem arises that which company is liable to prepare Consolidated Financial Statement taking A Ltd. as its subsidiary. For this purpose both B Ltd. and C Ltd. will prepare such Consolidated Financial Statement, group being constituted of themselves and A Ltd.

In addition to the above points, one should also consider the following points:

Determination of control in any company or organization, does not depend only on the share in capital, many a times even when the share in capital is less than 50% but still we consider the parent-subsidiary relationship as the voting power granted under special circumstances is more than 50%.

For example, ICICI Bank advanced loan of ₹ 40 crores to A Ltd., whose share capital is ₹ 10 crores only. As per the loan agreement, in case company defaults to repay the principal or to pay the interest on due date three times, ICICI Bank will have right to participate in the decision making of the company and this right will come to an end with the repayment of the loan amount with all its interest. On happening of the event, ICICI Bank got the voting right in the company meetings (Board and AGM) and as its advances to company is 80% of shares plus advances, bank carry 80% voting right and we can say that there exists a parent-subsidiary relationship, where A Ltd. is subsidiary of ICICI Bank.

Control is said to come into existence from the date when the conditions of such control are satisfied. If company does have control over the function of another company but consolidated financial statement is not prepared for the reason that there is restriction of impairing the resources then later, on removal of such restriction control will be said to come into existence but not from the date of such removal but from the date when such investments led to control.

21.9 Consolidation Procedures

In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line-by-line basis by adding together like items of assets, liabilities, income and expenses and then certain adjustments are made.

The consolidation adjustments required will vary depending on the circumstances. The adjustments include (but are not restricted to);

- The elimination of the cost of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary;
- recognition of goodwill or capital reserve, depending on whether the cost of the parent's investment in each subsidiary is greater than or less than the parent's portion of equity of each subsidiary at the date on which investment in the subsidiary is made;
- the identification of the minority interest in the profit or loss of consolidated subsidiaries for the reporting period;
- the identification of the minority interest in the net assets of consolidated subsidiaries for the reporting period;
- the elimination of all intra-group balances and intra-group transactions, and the resulting unrealised profits and losses;
- adjustment of the consolidated results for dividends related to outstanding cumulative preference shares of a subsidiary that are held by minority interests regardless of whether the dividends have been declared.

21.10 Cost of Control

- ♦ The cost of investment of the parent in each of its subsidiaries and the parent's share in equity of each subsidiary should be eliminated. For the purpose equity and investment as on the date of each investment is taken.
- ♦ On the date of investment if the cost of investment to the parent is more than share of equity in that particular subsidiary, the difference is taken as Goodwill in the consolidated statement.
- ♦ On the date of investment if the cost of investment to the parent is less than share of equity in that particular subsidiary, the difference is taken as Capital Reserve in the consolidated statement.

21.11 Illustrations

Illustration 1

A Ltd. acquired 60% shares of B Ltd. @ ₹ 20 per share. Following are the extract of Balance Sheet of B Ltd.:

	₹
10,00,000 Equity Shares of ₹ 10 each	*1,00,00,000*

10% Debentures	*10,00,000*
Trade payables	*5,00,000*
Fixed Assets	*70,00,000*
Investments	*45,00,000*
Current Assets	*68,00,000*
Loans & Advances	*22,00,000*

On the same day B Ltd. declared dividend at 20% and as agreed between both the companies fixed assets were to be depreciated @ 10% and investment to be taken at market value of ₹ 60,00,000. Calculate the Goodwill or Capital Reserve to be recorded in Consolidated Financial Statement.

Solution

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Fixed Assets	70,00,000	
Less: Value written off (70,00,000 x 10%)	(7,00,000)	63,00,000
Investments at Market value		60,00,000
Current Assets		68,00,000
Loans & Advances		22,00,000
Total Assets		2,13,00,000
Less: Total Liabilities: Trade payables	55,00,000	
10% Debentures	10,00,000	(65,00,000)
Equity		1,48,00,000
Majority Share in Equity (1,48,00,000 x 60%)		88,80,000
Less: Cost of Investment (10,00,000 x 60%) x 20	1,20,00,000	
Less: Dividend Received (6,00,000 x 2)	(12,00,000)	(1,08,00,000)
Goodwill		19,20,000

- Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.
- Goodwill and capital reserve of different subsidiaries can be adjusted to a net figure by the parent in consolidated financial statement.
- Goodwill of consolidated financial statement need not be written off to consolidated profit and loss account but test of impairment (Refer to AS 28) is made each time a consolidated financial statement is prepared.
- When share application money and allotment money is paid separately on different dates, then as per AS 21, date on which investment led to acquisition to control of subsidiary should be taken as date of investment, i.e., date of allotment.

- On the basis of above discussion, if control is gained in the subsidiary by a series of investments, then the date of the investment which led to holding-subsidiary relationship is taken into consideration and step by step calculations are made for each following investments.

Illustration 2

A Ltd. purchased 40% stake of B Ltd. for ₹ 12 per share. After two years A Ltd. decided to purchase another 40% share in B Ltd. B Ltd. has 1,00,00,000 equity shares of ₹ 10 each as fully paid up shares. The purchase deal was finalised on the following terms:

- *Purchase price per share to be calculated on the basis of average profit of last three years capitalised at 7.5%. Profits for last three years are ₹ 35 lacs, ₹ 65 lacs and ₹ 89 lacs.*
- *Total assets of B Ltd. of ₹ 11,50,00,000. Assets to be appreciated by ₹ 40,00,000.*
- *Of the External Trade payables for ₹ 2,50,00,000 one trade payable to whom ₹ 10,00,000 was due has expired and nothing is to be paid to settle this liability.*
- *B Ltd. will declare dividend @ 15%.*

Calculate the Goodwill or Capital Reserve for A Ltd. in Consolidated Financial Statement.

Solution

Calculation of Purchase Consideration

Particulars	₹
Profits for Last 3 years: First	89,00,000
Second	65,00,000
Third	35,00,000
Total profits for last 3 years	1,89,00,000
Average Profits (1,89,00,000/3)	63,00,000
Total value of B Ltd. (63,00,000/7.5%)	8,40,00,000
Number of Shares in B Ltd.	1,00,00,000
Value per Share	8.40
Purchase Consideration (1,00,00,000 x 40%) x 8.4	3,36,00,000

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Fixed Assets	11,50,00,000	
Add: Appreciation in value of the asset	4,0,00,000	11,90,00,000
Less: Trade payables	2,50,00,000	
Less: Amount to be written off	(10,00,000)	(2,40,00,000)
Net Asset		9,50,00,000
Share in Net Asset (9,50,00,000 x 80%)		7,60,00,000

Less: Cost of Investment: Purchase Consideration	3,36,00,000	
Less: Dividend Received (10,00,00,000 x 40% x 15%)	(60,00,000)	
	2,76,00,000	
Add: Investment (1,00,00,000 x 40% x 12)	4,80,00,000	(7,56,00,000)
Capital Reserve		4,00,000

21.12 Minority Interest

- From the net income of the subsidiary, amount proportionate to minority interest is calculated and adjusted with the group income i.e. it is deducted from the profit & loss account balance and added to minority interest, so that the income of the group belonging to the parent is identified separately.
- Care should be taken to adjust for the cumulative preference dividend and profits belonging to the preference shares (if any) in the minority interest for the preference shares not held by the consolidated group. This adjustment should be made irrespective of whether or not dividends have been declared.
- Minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:
  - (i) The amount of equity attributable to minorities at the date on which investment in a subsidiary is made and
  - (ii) The minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.
- If carrying amount and cost of investment are different, carrying amount is considered for the purpose.

Illustration 3

Following are the Balance Sheet of A Ltd. and B Ltd.

		₹ '000			*₹ '000*
Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Equity Shares	*6,000*	*5,000*	*Goodwill*	*100*	*20*
6% Preference shares	*-*	*1,000*	*Fixed Assets*	*3,850*	*2,750*
General Reserve	*1,200*	*800*	*Investment*	*1,620*	*1,100*
Profit & Loss Account	*1,020*	*1,790*	*Inventory*	*1,900*	*4,150*
Trade payables	*3,850*	*3,410*	*Trade receivables*	*4,600*	*4,080*
Proposed Dividend	*600*	*500*	*Cash & Bank*	*600*	*400*
	12,670	*12,500*		*12,670*	*12,500*

A Ltd. purchased 3/4th interest in B Ltd. at the beginning of the year at the premium of 25%. Following are the other information available:

a. *Profit & Loss Account of B Ltd. includes ₹ 1,000 thousands bought forward from the previous year.*

b. *The directors of both the companies have proposed a dividend of 10% on equity share capital for the previous and current year.*

From the above information calculate Pre and Post Acquisition Profits, Minority Interest and Cost of Control.

Solution

Calculation of Pre and Post Acquisition Profits

Particulars	*Pre Acquisition Profits*	*(₹) Post Acquisition Profits*
Profit & Loss Account	10,00,000	7,90,000
General Reserve	800,000	-
	18,00,000	7,90,000
Less: Minority Interest (1800/4)	(4,50,000)	
(790/4)		(1,97,500)
Consolidated Balance Sheet	13,50,000	5,92,500

Calculation of Minority Interest

Particulars	₹
Paid up Equity Share Capital (50,00,000/4)	12,50,000
Paid up Preference Share Capital	10,00,000
Pre Acquisition Profits	4,50,000
Post Acquisition Profits	1,97,500
Minority Interest	28,97,500

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Cost of Investment in Subsidiary (50,00,000 x 75% x 125%)	46,87,500	
Less: Dividend Received (50,00,000 x 75% x 10%)	(3,75,000)	43,12,500
Less: Paid up Capital	37,50,000	
Pre Acquisition Profits	13,50,000	(51,00,000)
Capital Reserve		7,87,500

- The losses applicable to the minority are deducted from the minority interest unless minority interest is nil. Any further loss is adjusted with the consolidated group interest except to the extent that the minority has a binding obligation to, and is able to, make the losses good. Subsequently, when the particular subsidiary makes profits, minority share in profits is added to majority share to the extent minority interest losses were absorbed by majority share.

  For example, 25% minority interest has the share in net equity ₹ 40 lacs and company made cumulative losses since the date of investment ₹ 200 lacs. 25% of ₹ 200 lacs, ₹ 50 lacs are minority share in losses. Losses upto ₹ 40 lacs will be adjusted with the minority interest and further loss of ₹ 10 lacs will be adjusted with the majority interest. Hence in the Consolidated Balance Sheet for the relevant year, minority interest on the liabilities side will be NIL.

In the next year, if subsidiary company makes a profit say, ₹ 60 lacs. Minority interest comes to ₹ 15 lacs, out of these 15 lacs, first ₹ 10 lacs will be added to majority interest as recovery of losses absorbed in past and balance ₹ 5 lacs will appear in Consolidated Balance Sheet as part of the Minority Interest.

21.13 Other Points

General rules: In order to present financial statements for the group in a consolidated format, the effect of transactions between group enterprises should be eliminated. AS 21 requires that intra-group transactions (including sales, expenses and dividends) and the resulting unrealised profits and losses be eliminated in full.

Liabilities due to one group enterprise by another will be set off against the corresponding asset in the other group enterprise's financial statements; sales made by one group enterprise to another should be excluded both from turnover and from cost of sales or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying enterprise has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets reduced to cost to the group.

For transactions between group enterprises, unrealised profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and tangible fixed assets, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

Unrealised profit in inventories: Where a group enterprise sells goods to another, the selling enterprise, as a separate legal enterprise, records profits made on those sales. If these goods are still held in inventory by the buying enterprise at the year end, however, the profit recorded by the selling enterprise, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealised profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

When the goods are sold by a parent to a subsidiary (downstream transaction), all of the profit on the transaction is eliminated, irrespective of the percentage of the shares held by the parent. In other words, the group is not permitted to take credit for the share of profit that is attributable to any minority.

Where the goods are sold by a subsidiary, in which there is a minority interest, to another group enterprise (upstream transaction), the whole of the unrealised profit should also be eliminated.

Unrealised profit on transfer or non-current assets

- Similar to the treatment described above for unrealised profits in inventories, unrealised inter-company profits arising from intra-group transfers of fixed assets are also eliminated from the consolidated financial statements. **Intra Group Transactions:** The effect of any unrealised profits from inter group transactions should be eliminated from consolidated financial statement. Effect of losses from inter group transactions need not be eliminated only when the cost is not recoverable.

  For example, A Ltd. sold goods for ₹ 1,25,000 to B Ltd., another subsidiary under same group at the gross profit of 20% on sales. On the date of consolidated balance sheet, B Ltd. has goods worth ₹ 25,000 as inventory from the same consignment. The unrealised profits of ₹ 5,000 (25,0000 x 20%) will be deducted from the closing inventory and it will be valued as ₹ 20,000 i.e. at cost to A Ltd. for the purpose of Consolidated Financial Statement.

- **Reporting Date:** For the purposes of preparing consolidated financial statements, the financial statements of all subsidiaries should, wherever practicable, be prepared:

  - To the same reporting date; and
  - For the same reporting period as of the parent.

- If practically it is not possible to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the parent, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.

- **Accounting Policies:** Accounting policies followed in the preparation of the financial statements of the parent, subsidiaries and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

  If accounting policies followed by different companies in the group are not uniform, then adjustments should be made in the items of the subsidiaries to bring them in line with the accounting policy of the parent. Here we will not disturb the figures or policies in respective books, but while including the items in consolidated financial statement, adequate adjustments will be made.

  For example, parent company A Ltd. is valuing the inventory on weighted average basis and its inventory is valued as ₹ 100 lacs but its subsidiary B Ltd. is following FIFO method and its inventory is valued at ₹ 20 Lacs. Inventory of B Ltd. will be valued under weighted average method say, ₹ 25 lacs. Now for the purpose of consolidated financial statement, inventory of B Ltd. will taken as ₹ 25 lacs and the inventory disclosed in consolidated trading account on credit side and in consolidated balance sheet assets side will be ₹ 125 lacs. Hence adequate adjustments are made for this ₹ 5 lac in consolidated financial statement.

If it is not practical to make such adjustments for uniform accounting policies in preparing the consolidated financial statements, then the fact should be disclosed together with the amounts of the each items in the consolidated financial statement to which the different accounting policies have been applied.

Let us take above example, incase it is not possible practically to adjust ₹ 5 lacs in the inventory of B Ltd. for the purpose of consolidated financial statement, then item will be disclosed in Consolidated Trading Account (Credit Side) and Consolidated Balance Sheet (Asset Side) as follow:

Closing Inventory of A Ltd. (Weighted Average Method)	100 lacs	
Closing Inventory of B Ltd. (FIFO Method)	25 lacs	125 lacs

21.14 Disposal of Holding

The results of operations of a subsidiary are included in the consolidated financial statement as from the date on which parent-subsidiary relationship comes into existence and are included in the consolidated statement of profit and loss until the date of cessation of the relationship. On disposal of the investment, consolidated profit and loss account will include the transactions till the date the parent-subsidiary relationship ceases to exist. The difference between the proceeds from the disposal of investment and the parent's share in the net asset of the subsidiary on the basis of the carrying amount, on the date of disposal is recorded in the consolidated profit and loss account. While calculating the share of parent in the net asset of the subsidiary on the date of disposal, adjustment is made for the minority interest calculated as above.

In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.

Investment in the subsidiary, in the separate financial statement of the parent is recorded according to the provisions of AS 13.

Illustration 4

A Ltd. had acquired 80% share in the B Ltd. for ₹ 25 lacs. The net assets of B Ltd. on the day are ₹ 22 lacs. During the year A Ltd. sold the investment for ₹ 30 lacs and net assets of B Ltd. on the date of disposal was ₹ 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

Solution

Calculation of Profit/Loss on disposal of investment in subsidiary

Particulars	₹	₹
Net Assets of B Ltd. on the date of disposal		35,00,000
Less: Minority Interest (35 lacs x 20%)		(7,00,000)
A Ltd.'s Share in Net Assets		28,00,000
Proceeds from the sale of Investment		30,00,000
Less: A Ltd.'s share in net assets		(28,00,000)
		2,00,000
Less: Goodwill in the Consolidated Financial Statement		
Cost of investment	25,00,000	
Less: A Ltd.'s Share in net asset on the date (22 lacs x 80%)	(17,60,000)	(7,40,000)
Loss on sale of investment		5,40,000

Illustration 5

A Ltd. had acquired 80% share in the B Ltd. for ₹ 15 lacs. The net assets of B Ltd. on the day are ₹ 22 lacs. During the year A Ltd. sold the investment for ₹ 30 lacs and net assets of B Ltd. on the date of disposal was ₹ 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

Solution

Calculation of Profit/Loss on disposal of investment in subsidiary

Particulars	₹	₹
Net Assets of B Ltd. on the date of disposal		35,00,000
Less: Minority Interest (35 lacs x 20%)		(7,00,000)
A Ltd.'s Share in Net Assets		28,00,000
Proceeds from the sale of Investment		30,00,000
Less: A Ltd.'s share in net assets		28,00,000
		2,00,000
Less: Capital Reserve in the Consolidated Financial Statement		
A Ltd.'s Share in net asset on the date (22 lacs x 80%)	17,60,000	
Less: Cost of investment	15,00,000	2,60,000
Profit on sale of investment		4,60,000

21.15 Disclosure

In addition to disclosures required by paragraph 11 and 20, following disclosures should be made:

a. In the consolidated financial statements a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;

b. In consolidated financial statements, where applicable:

   (i) The nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;

   (ii) The effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and

   (iii) The names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

21.16 Transitional Provisions

On the first occasion that consolidated financial statements are presented, comparative figures for the previous period need not be presented. In all subsequent years full comparative figures for the previous period should be presented in the consolidated financial statements.

21.17 Accounting for Taxes on Income in the Consolidated Financial Statements

While preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

The amounts of tax expense appearing in the separate financial statements of a parent and its subsidiaries do not require any adjustment for the purpose of consolidated financial statements. In view of this, while preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements is the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

Reference: The students are advised to refer the full text of AS 21 "Consolidated Financial Statements" (issued 2001).

UNIT 22 : AS 22: ACCOUNTING FOR TAXES ON INCOME

22.1 Introduction

AS 22 was issued in 2001 and is mandatory in nature for:

a. All the accounting periods commencing on or after 01.04.2001, in respect of the following:

   (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

   (ii) All the enterprises of a group, if the parent presents consolidated financial statements and the Accounting Standard is mandatory in nature in respect of any of the enterprises of that group in terms of (i) above.

b. All the accounting periods commencing on or after 01.04.2002, in respect of companies not covered by (a) above.

c. All the accounting periods commencing on or after 01.04.2003, in respect of all other enterprises.

This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

22.2 Need

Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons.

Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes, known as Permanent Difference.

Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and the corresponding amount which is recognised for the computation of taxable income, known as Time Difference.

22.3 Definitions

Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income-tax expense or adding income tax saving.

Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income-tax payable (recoverable) is determined.

Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

Current tax is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

Deferred tax is the tax effect of timing differences.

The differences between taxable income and accounting income can be classified into permanent differences and timing differences.

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

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

22.4 Recognition

Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

Permanent differences do not result in deferred tax assets or deferred tax liabilities. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet.

While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

22.5 Re-assessment of Unrecognised Deferred Tax Assets

At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realised.

22.6 Measurement

Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws. Deferred tax assets and liabilities should not be discounted to their present value.

22.7 Review of Deferred Tax Assets

The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

22.8 Disclosure

Statement of profit and loss

Under AS 22, there is no specific requirement to disclose current tax and deferred tax in the statement of profit and loss. However, under company law requirements, the amount of Indian income tax and other Indian taxation on profits, including, wherever practicable, with Indian income tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income tax and distinguishing, wherever practicable, between income tax and other taxation should be disclosed.

AS 22 does not require any reconciliation between accounting profit and the tax expense.

Balance sheet

The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts.

Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

An enterprise should offset assets and liabilities representing current tax if the enterprise:

a. Has a legally enforceable right to set off the recognised amounts and

b. Intends to settle the asset and the liability on a net basis.

An enterprise should offset deferred tax assets and deferred tax liabilities if:

a. The enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

b. The deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

22.9 Transitional Provision

On the first occasion that the taxes on income are accounted for in accordance with this Statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Statement had been in effect from the beginning.

The Background material on AS 22 further clarifies that in case an enterprise does not have adequate revenue reserves to adjust the accumulated balance of deferred tax liability, it should be adjusted to the extent not adjusted against revenue reserves, against opening balance of profit and loss account. Where the opening balance of profit and loss is also inadequate, it should be shown, to the extent not adjusted, as 'Debit balance in Profit and Loss Account' on the asset side of the balance sheet. The accumulated deferred tax liability cannot be adjusted against securities premium.

22.10 Relevant Explanations to AS 22

Accounting for Taxes on Income in the situations of Tax Holiday under sections 80-IA and 80-IB of the Income Tax Act, 1961

The deferred tax in respect of timing differences which reverse during the tax holiday period should not be recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of the Act. Deferred tax in respect of timing differences which reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the situations of Tax Holiday under sections 10A and 10B of the Income Tax Act, 1961

The deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the context of section 115JB of the Income Tax Act, 1961

The payment of tax under section 115JB of the Act is a current tax for the period. In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act. In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act.

Virtual Certainity suppored by convincing evidence

Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and it should be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

22.11 Miscellaneous Illustrations

Illustration 1

From the following details of A Ltd. for the year ended 31-03-2012, calculate the deferred tax asset/ liability as per AS 22

Particulars	*₹*
Accounting Profit	*6,00,000*
Book Profit as per MAT	*3,50,000*
Profit as per Income Tax Act	*60,000*
Tax rate	*20%*
MAT rate	*7.50%*

Solution

Tax as per accounting profit 6,00,000×20%= ₹ 1,20,000

Tax as per Income-tax Profit 60,000×20% =₹ 12,000

Tax as per MAT 3,50,000×7.50%= ₹ 26,250

Tax expense= Current Tax +Deferred Tax

₹ 1,50,000 = ₹ 15,000+ Deferred tax

Therefore, Deferred Tax liability as on 31-03-2012

= ₹ 1,20,000 – ₹ 12,000 = ₹ 1,08,000

Amount of tax to be debited in Profit and Loss account for the year 31-03-2012

Current Tax + Deferred Tax liability + Excess of MAT over current tax

= ₹ 12,000 + ₹ 1,08,000 + ₹ 14,250

= ₹ 1,34,250

Illustration 2

Ultra Ltd. has provided the following information.

Depreciation as per accounting records =₹ 2,00,000

Depreciation as per tax records =₹ 5,00,000

Unamotised preliminary expenses as per tax record = ₹ 30,000

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

Solution

Calculation of difference between taxable income and accounting income

Particulars	*Amount (₹)*
Excess depreciation as per tax ₹ (5,00,000 – 2,00,000)	3,00,000
Less: Expenses provided in taxable income	(30,000)
Timing difference	2,70,000

Tax expense is more than the current tax due to timing difference.

Therefore deferred tax liability = 50%*2,70,000 = ₹ 1,35,000

Illustration 3

XYZ is an export oriented unit and was enjoying tax holiday upto 31.3.2011. No provision for deferred tax liability was made in accounts for the year ended 31.3.2011. While finalising the accounts for the year ended 31.3.2012, the Accountant says that the entire deferred tax liability upto 31.3.2011 and current year deferred tax liability should be routed through Profit and Loss Account as the relevant Accounting Standard has already become mandatory from 1.4.2001. Do you agree?

Solution

Paragraph 33 of AS 22 on “Accounting For Taxes on Income” relates to the transitional provisions. It says, "On the first occasion that the taxes on income are accounted for in accordance with this statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets.

Further Paragraph 34 lays down, "For the purpose of determining accumulated deferred tax in the period in which this statement is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are compared and the differences, if any, are determined. The tax effects of these differences, if any, should be recognised as deferred tax assets or liabilities, if these differences are timing differences."

Therefore, in the case of XYZ, even though AS 22 has come into effect from 1.4.2001, the transitional provisions permit adjustment of deferred tax liability/asset upto the previous year to be adjusted from opening reserve. In other words, the deferred taxes not provided for alone can be adjusted against opening reserves.

Provision for deferred tax asset/liability for the current year should be routed through profit and loss account like normal provision.

Illustration 4

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of ₹ 2,00,000 for the year ending 31.3.20108. For the years ending 31.3.2011 and 31.3.2012, it made profits of ₹ 1,00,000 and ₹ 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.2010, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 2011 and 2012 for tax purposes. Prepare a statement of Profit and Loss for the years ending 2010, 2011 and 2012.

Solution

Statement of Profit and Loss

	31.3.2010 ₹	*31.3.2011* ₹	*31.3.2012* ₹
Profit (Loss)	(2,00,000)	1,00,000	1,20,000
Less: Current tax			(8,000)
Deferred tax:			
Tax effect of timing differences originating during the year	80,000		
Tax effect of timing differences reversed/adjusted during the year		(40,000)	(40,000)
Profit (Loss) After Tax Effect	(1,20,000)	60,000	72,000

Illustration 5

The following particulars are stated in the Balance Sheet of M/s Exe Ltd. as on 31.03.2011:

	(₹ in Lakhs)
Deferred Tax Liability (Cr.)	*20.00*
Deferred Tax Assets (Dr.)	*10.00*

The following transactions were reported during the year 2011-12:

(i)	*Tax Rate*	*50%*
(ii)	*Depreciation – As per Books*	*50.00*
	Depreciation – for Tax purposes	*30.00*
	There were no addition to Fixed Assets during the year.	
(iii)	*Items disallowed in 2010-11 and allowed for Tax purposes in 2011-12*	*10.00*
(iv)	*Interest to Financial Institutions accounted in the Books on accrual basis, but actual payment was made on 30.09.2012*	*20.00*
(v)	*Donations to Private Trusts made in 2011-12*	*10.00*
(vi)	*Share issue expenses allowed under 35(D) of the I.T. Act, 1961 for the year 2011-12 (1/10th of ₹ 50.00 lakhs incurred in 2010-2011)*	*5.00*
(vii)	*Repairs to Plant and Machinery ₹100.00 lakhs was spread over the period 2011-12 and 2012-13 equally in the books. However, the entire expenditure was allowed for Income-tax purposes.*	

Indicate clearly the impact of above items in terms of Deferred Tax liability/Deferred Tax Assets and the balances of Deferred Tax Liability/Deferred Tax Asset as on 31.03.2012.

Solution

Impact of various items in terms of deferred tax liability/deferred tax asset

Transactions	*Analysis*	*Nature of difference*	*Effect*	*Amount*
Difference in depreciation	Generally, written down value method of depreciation is adopted under IT Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years.	Responding timing difference	Reversal of DTL	₹ 20 lakhs × 50% = ₹ 10 lakhs
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Responding timing difference	Reversal of DTA	₹ 10 lakhs × 50% = ₹ 5 lakhs
Interest to financial institutions	It is allowed as deduction under section 43B of the IT Act, if the payment is made before the due date of filing the return of income (i.e. 31st October, 2012).	No timing difference	Not applicable	Not applicable

Donation to private trusts	Not an allowable expenditure under IT Act.	Permanent difference	Not applicable	Not applicable
Share issue expenses	Due to disallowance of full expenditure under IT Act, tax payable in the earlier years was higher.	Responding timing difference	Reversal of DTA	₹ 5 lakhs × 50% = ₹ 2.5 lakhs
Repairs to plant and machinery	Due to allowance of full expenditure under IT Act, tax payable of the current year will be less.	Originating timing difference	Increase in DTL	₹ 50 lakhs × 50% = ₹ 25 lakhs

Deferred Tax Liability Account

			₹ *in lakhs*				₹ *in lakhs*
31.3.2012	To	Profit and Loss account (Depreciation)	10.00	1.4.2011	By	Balance b/d	20.00
	To	Balance c/d	35.00		By	Profit and Loss Account (Repairs to plant)	25.00
			45.00				45.00
				1.4.2012	By	Balance b/d	35.00

Deferred Tax Asset Account

			₹ *in lakhs*				₹ *in lakhs*
1.4.2011	To	Balance b/d	10.00	31.3.2012	By	Profit and Loss Account: Items disallowed in 2010-11 and allowed as per I.T. Act in 2011-12	5.00
						Share issue expenses	2.50
					By	Balance c/d	2.50
			10.00				10.00
1.4.2012	To	Balance b/d	2.50				

Note: An Exposure Draft of the limited revisions to Accounting Standard (AS) 22, "Accounting for Taxes on Income" has been issued to synchronise the presentation requirements of AS 22, with the presentation requirements prescribed under revised Schedule VI notified under the Companies Act, 1956 (Now Schedule III of the Companies Act, 2013). It is pertinent to note that this Limited Revision is still in the form of exposure draft and will come into effect as and when it will be notified by the Government.

Reference: The students are advised to refer the full text of AS 22 "accounting for taxes on income" (issued 2001).

UNIT 23 : AS 23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

23.1 Introduction

AS 23, comes into effect in respect of accounting periods commencing on or after 1-4-2002. AS 23 describes the principles and procedures for recognizing investments in associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in the consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable.

23.2 Objective

The objective of this Statement is to lay down principles and procedures for recognizing the investments in associates and its effect on the financial operations of the group in the consolidated financial statement. Reference to AS 23 is compulsory for the companies following AS 21 and preparing consolidated financial statement for their group. For disclosing investment in associates in the separate financial statement of the investor itself, one should follow AS 13.

23.3 Definitions of the terms used in the Accounting Standard

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities. **Consolidated financial statements** are the financial statements of a group presented as those of a single enterprise.

An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Significant influence is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies. This definition excludes the subsidiaries or joint venture from the scope of an associate but apart from these any other enterprises, which are significantly influenced by the investor is an associate for the purpose of this standard. Any enterprise having 20% or more control over voting power or any interest directly or indirectly in any other enterprise will be assumed to have significantly influencing the other enterprise unless proved otherwise. Similarly any enterprise that does not have 20% or more control then it is assumed not having significant influence on the enterprise unless proved otherwise.

An enterprise can influence the significant economic decision making by many ways like:

- Having some voting power.

- ♦ Representation on the board of directors or governing body of the investee.
- ♦ Participation in policy-making processes.
- ♦ Interchange of managerial personnel.
- ♦ Provision of essential technical information.
- ♦ Influencing inter company transactions i.e. sale of goods and services, sharing technical knowledge etc.

As a general rule, significant influence is presumed to exist when an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee.

As with the classification of any investment, the substance of the arrangement in each case should be considered. If it can be clearly demonstrated that an investor holding 20% or more of the voting power of the investee does not have significant influence, the investment will not be accounted for as an associate.

A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

If the investor holds, directly or indirectly through subsidiaries, less then 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. The presence of one or more of the indicators as above may indicate that an investor has significant influence over a less than 20% owned corporate investee.

Control exists when parent company has either:

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

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

   If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

   An enterprise is considered to control the composition of the board of directors or governing body of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body. An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

   (i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or

   (ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or

(iii) The director/member is nominated by that enterprise or a subsidiary thereof.

To understand the above definitions let us take few examples:

Example1: A Ltd. has 70% holding in C Ltd. and B Ltd. also has 28% holding in the same company. So, A Ltd. with the majority holding i.e. more than 50% is the parent company and C Ltd. with more than 20% share though minor but a business associate.

Example 2: A Ltd. holding 90% share in B Ltd. and 10% in C Ltd., and also B Ltd. holding 11% shares in C Ltd. In this case, A Ltd. is parent of B Ltd. but due to total of direct and indirect holding of (10 + 11) 21% in C Ltd., C Ltd. is an associate of A Ltd. Though for consolidated financial statement purpose, these holding will be 19.9% (10% + 90% of 11%), as rest 1.1% belongs to minority interest.

23.4 Associates Accounted for using the the Equity method

The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

From the definition, following broad conclusions can be drawn:

a. In CFS, investment is to be recorded at cost.

b. Any surplus or deficit in cost and net asset to be recorded as goodwill or capital reserve.

c. Distributions received from an investee reduce the carrying amount of the investment.

d. Any subsequent change in share in net asset is adjusted in cost of investment and goodwill/capital reserve.

e. Consolidated Profit & Loss shows the investor's share in the results of operations of the investee.

Illustration 1

A Ltd. acquire 45% of B Ltd. shares on April 01, 2011, the price paid was ₹ 15,00,000. Following are the extract of balance sheet of B Ltd.:

Paid up Equity Share Capital	*₹ 10,00,000*
Securities Premium	*₹ 1,00,000*
Reserve & Surplus	*₹ 5,00,000*

B Ltd. has reported net profits of ₹ 3,00,000 and paid dividends of ₹ 1,00,000. Calculate the amount at which the investment in B Ltd. should be shown in the consolidated balance sheet of A Ltd. as on March 31, 2012.

Solution

Calculation of the carrying amount of Investment as per equity method

Particulars	₹	₹
Equity Shares	10,00,000	
Security Premium	1,00,000	
Reserves & Surplus	5,00,000	
Net Assets	16,00,000	
45% of Net Asset	7,20,000	
Add: 45% of Profits for the year	1,35,000	
	8,55,000	
Less: Dividend Received	45,000	8,10,000
Less: Cost of Investment		(15,00,000)
Goodwill		6,90,000

Consolidated Balance Sheet (Extract)

Assets	₹	₹
Investment in B Ltd.	810,000	
Add: Goodwill	690,000	1,500,000

23.5 Circumstances under which Equity Method is followed

Equity method of accounting is to be followed by all the enterprises having significant influence on their associates except in the following cases:

a. Control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

b. The term 'Near Future' is explained with AS 21.

   Or it operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor.

   In both the above cases, investment of investor in the share of the investee is treated as investment according to AS 13.

An investor should discontinue the use of the equity method from the date that:

a. It ceases to have significant influence in an associate but retains, either in whole or in part, its investment.

b. The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with AS 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.

23.6 Application of the Equity Method

- Many of the rules followed under equity method for an associate is similar to consolidated financial statement rules as in case of subsidiary i.e. AS 21.
- Investment in an associate should be recorded as equity from the date when such relation comes in effect.
- Investment in the associate is recorded at cost and any difference in the cost and investor's share in equity on the date of acquisition is shown as goodwill or capital reserve.

  Case 1: A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment ₹ 33,000 and Total Equity on the date of acquisition ₹ 2,00,000.

A Ltd.'s share in equity (2,00,000 x 22%)	₹ 44,000
Less: Cost of Investment	₹ (33,000)
Capital Reserve	₹ 11,000

Extract of Balance Sheet

Assets	₹	₹
Investment in B Ltd.	44,000	
Less: Goodwill	(11,000)	33,000

  Case 2: A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment ₹ 55,000 and Total Equity on the date of acquisition ₹ 2,00,000.

Cost of Investment	₹ 55,000
Less: A Ltd.'s share in equity (2,00,000 x 22%)	₹ 44,000
Goodwill	₹ 11,000

Extract of Balance Sheet

Assets	₹	₹
Investment in B Ltd.	44,000	
Add: Goodwill	11,000	55,000

- An enterprise having share of profits of more then 50% in other company, they are classified as Parent-Subsidiary relationship. Share in profits less then 51% but more than 20% then this relationship is termed as associate relationship. This stake of 20% can be acquired either in one go or in more than one transaction. This share of stake can be increased further say from 25% to 30%. Adjustment should be made with each transaction.

  Case 1: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 during the same year. Other information is as follow:

Cost of Investment for 10% ₹ 1,00,000 and for 15% ₹ 1,45,000

Net asset on April 01st ₹ 8,50,000 and on October 01st ₹ 10,00,000.

Calculations for April 01:

Cost of investment	₹ 1,00,000
10% share in net asset	₹ 85,000
Goodwill	₹ 15,000

Calculations for October 01:

15% share in net asset	₹ 1,50,000
Cost of investment	₹ 1,45,000
Capital Reserve	₹ 5,000
Total goodwill (15,000 – 5,000)	₹ 10,000

Case 2: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 of the same year. Other information is as follow:

Cost of Investment for 10% ₹ 1,00,000 and for 15% ₹ 1,55,000

Net asset on April 01st ₹ 8,50,000 and on October 01st ₹ 10,00,000.

Calculations for April 01:

Cost of investment	₹ 1,00,000
10% share in net asset	₹ 85,000
Goodwill	₹ 15,000

Calculations for October 01:

Cost of investment	₹ 1,55,000
15% share in net asset	₹ 1,50,000
Goodwill	₹ 5,000
Total goodwill (15,000 + 5,000)	₹ 20,000

Case 3: A Ltd. acquired 25% stake of B Ltd. on April 01 and further 5% on October 01 of the same year. Other information is as follow:

Cost of Investment for 25% ₹ 1,50,000 and for 5% ₹ 20,000

Net asset on April 01st ₹ 5,00,000.

Profit for the year ₹ 90,000 earned in the ratio 2:1 respectively.

Calculations for April 01:

Cost of investment	₹ 1,50,000
25% share in net asset	₹ 1,25,000
Goodwill	₹ 25,000

Calculations for October 01:

Profits for the first half (90,000/3) x 2	₹ 60,000
Additional share of A Ltd.	5%
Pre-acquisition profits i.e. capital reserve (60,000 x 5%)	₹ 3,000
5% share in net asset	₹ 25,000
Cost of investment	₹ 20,000
Capital Reserve	₹ 5,000
Cost of Investment on April 01st	₹ 1,50,000
Less: Goodwill	₹ 25,000
Carrying Amount on April 01st	₹ 1,25,000
Add: Additional Share in Net Asset on October 01st	₹ 25,000
Add: Capital share of Profits for first half	₹ 3,000
Add: Revenue shares of Profits for first half (60,000 x 25%)	₹ 15,000
Add: Revenue shares of Profits for second half (30,000 x 30%)	₹ 9,000
Total Carrying Amount on March 31st	₹ 1,77,000

♦ If there is any transaction between the Investor Company and investee concern then the unrealised profits on such goods to the extent of investor's share should be eliminated from consolidated financial statement. As in the above example, the profits calculated on the goods lying with the buyer on the date of statement, will be eliminated to the extent of investor's share i.e. 22%.

♦ Any lose on such transactions are not eliminated to the extent that such loss is not recoverable. Otherwise such losses are written off from consolidated financial statement fully.

Illustration 2

A Ltd. acquired 40% share in B Ltd. on April 01, 2009 for ₹ 10 lacs. On that date B Ltd. had 1,00,000 equity shares of ₹ 10 each fully paid and accumulated profits of ₹ 2,00,000. During the year 2009-10, B Ltd. suffered a loss of ₹ 10,00,000; during 2010-11 loss of ₹ 12,50,000 and during 2011-12 again a loss of ₹ 5,00,000. Show the extract of consolidated balance sheet of A Ltd. on all the four dates recording the above events.

Solution

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	₹
Equity Shares	10,00,000
Reserves & Surplus	2,00,000
Net Assets	12,00,000
40% of Net Asset	4,80,000
Less: Cost of Investment	(10,00,000)
Goodwill	5,20,000

Consolidated Balance Sheet (Extract) as on April 01, 2009

Assets	₹	₹
Investment in B Ltd.	480,000	
Add: Goodwill	520,000	1,000,000

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	₹
Investment in B Ltd.	4,80,000
Add: Goodwill	5,20,000
Cost of Investment	10,00,000
Less: Loss for the year (10,00,000 x 40%)	(4,00,000)
Carrying Amount of Investment	6,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2010

Assets	₹	₹
Investment in B Ltd.	80,000	
Add: Goodwill	5,20,000	6,00,000

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	₹
Carrying Amount of Investment	6,00,000
Less: Loss for the year (12,50,000 x 40%)	(5,00,000)
Carrying Amount of Investment	1,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2011

Assets	₹	₹
Investment in B Ltd.	-	
Add: Goodwill	1,00,000	1,00,000

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	₹
Carrying Amount of Investment	1,00,000
Less: Loss for the year (5,00,000 x 40%)	2,00,000
Carrying Amount of Investment	(1,00,000)

Consolidated Balance Sheet (Extract) as on March 31, 2012

Assets	₹	₹
Investment in B Ltd.		-

- As far as possible the reporting date of the financial statements should be same for consolidated financial statement. If practically it is not possible to draw up the financial statements of one or more enterprise to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the investor, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the consolidated financial statements. In any case, the difference between reporting dates of the concern and consolidated financial statement should not be more than six months.
- Accounting policies followed in the preparation of the financial statements of the investor, investee and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

  If accounting policies followed by different enterprises in the group are not uniform, then adjustments should be made in the items of the individual financial statements to bring it in line with the accounting policy of the consolidated statement.

The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

23.7 Contingencies

In accordance with AS 4, the investor discloses in the consolidated financial statements:

a. Its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and

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

23.8 Disclosure

- In addition to the disclosures required above, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.
- Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.
- The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.
- In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the

associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.

- ♦ If an associate is not accounted for using the equity method the reasons for not doing the same.
- ♦ Goodwill/capital reserve arising on the acquisition of an associate by an investor should be disclosed separately though it is included in the carrying amount of the investment.

23.9 Transitional Provisions

On the first occasion when investment in an associate is accounted for in consolidated financial statements in accordance with this Statement, the carrying amount of investment in the associate should be brought to the amount that would have resulted had the equity method of accounting been followed as per this Statement since the acquisition of the associate. The corresponding adjustment in this regard should be made in the retained earnings in the consolidated financial statements.

23.10 Relevant Explanations to AS 23

Treatment of Proposed Dividend in Associates in Consolidated Financial Statements:

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

Consideration of Potential Equity Shares for Determining whether an Investee is an Associate, Accounting for Investments in Associates in Consolidated Financial Statements:

The potential equity shares of the investee held by the investor should not be taken into account for determining the voting power of the investor.

Illustration 3

On April 01, 2010, A Ltd. acquired 25% shares of C Ltd. for ₹ 5,00,000 and subscribed for 100% shares of a new company B Ltd. promoted by the management of A Ltd. Following are the summarized balance sheet of all the three companies:

Summarised Balance Sheet as on April 01, 2010 (Fig. in '000)

Liabilities	*A Ltd. ₹*	*B Ltd. ₹*	*C Ltd. ₹*	*Assets*	*A Ltd. ₹*	*B Ltd. ₹*	*C Ltd. ₹*
Equity Shares of ₹ 10 each	5,000	1,000	1,000	*Fixed Assets*	7,000	-	2,500
Profit & Loss A/c	6,500	-	2,300	*Investment*	1,500	-	2,000
Current Liabilities	2,500	-	3,700	*Current Assets*	5,500	1,000	2,500
	14,000	1,000	7,000		14,000	1,000	7,000

On March 31, 2011 A Ltd. purchased another 50% share of C Ltd. from the open market for ₹ 40,00,000

Liabilities	*A Ltd. ₹*	*B Ltd. ₹*	*C Ltd. ₹*	*Assets*	*A Ltd. ₹*	*B Ltd. ₹*
Equity Shares of ₹10 each						
Profit & Loss A/c	*7,900*	*500*	*4,500*	*Investment*	*5,500*	*1,000*
Current Liabilities	*15,000*	*3,000*	*10,000*		*15,000*	*3,000*

Summarised Balance Sheet as on March 31, 2012 (Fig. in '000)

Liabilities	*A Ltd. ₹*	*B Ltd. ₹*	*C Ltd. ₹*	*Assets*	*A Ltd. ₹*	*B Ltd. ₹*	*C Ltd. ₹*
Equity Shares of ₹10 each	*5,000*	*1,000*	*1,000*	*Fixed Assets*	*5,700*	*900*	*2,100*
Profit & Loss A/c	*9,000*	*1,500*	*5,100*	*Investment*	*2,800*	*2,000*	*3,500*
Current Liabilities				*Current Assets*			
	3,000	*2,500*	*3,900*		*8,500*	*2,100*	*4,400*
	17,000	*5,000*	*10,000*		*17,000*	*5,000*	*10,000*

You are required to prepare Consolidated Profit & Loss Account for the year ended on 31/03/2011 and 31/03/2012, also prepare Consolidated Balance Sheet as on 01/04/2010, 31/03/2011 and 31/03/2012.

Solution

Calculation of Goodwill / Capital Reserve

Particulars	₹
Equity Share Capital of C Ltd.	1,000,000
Profit & Loss Account	2,300,000
Net Assets	3,300,000
25% of Net Asset	825,000
Less: Cost of Investment	500,000
Capital Reserve	325,000

Consolidated Balance Sheet as on April 01, 2010

		(₹)
I	I. Equity and liabilities	
	(1) Shareholders' funds:	
	(a) Capital	50,00,000
	(b) Reserves and surplus	65,00,000
	(2) Current liabilities	25,00,000
	TOTAL	1,40,00,000

II	Assets	
	(1) Non-current Assets	
	(a) Fixed assets:	70,00,000
	(b) Non-current investments (Note 1)	5,00,000
	(2) Current assets	65,00,000
	TOTAL	14,00,000

Note to Accounts

1.	Non-current investments		(₹)
	Investment in Associates	8,25,000	
	Less: Capital Reserve	(3,25,000)	5,00,000

Calculation of Goodwill/Capital Reserve

Particulars	₹
Equity Share Capital of C Ltd.	10,00,000
Profit & Loss Account	45,00,000
Net Assets	55,00,000
75% of Net Asset	41,25,000
Less: Cost of Investment	(45,00,000)
Goodwill	3,75,000

Draft Consolidated Profit & Loss for the year ended on March 31, 2011

Particulars	₹	*Particulars*	₹	₹
		Balance b/d		65,00,000
		Profits of A Ltd.	14,00,000	
Balance c/d	84,00,000	Profits of B Ltd.	5,00,000	19,00,000
	84,00,000			84,00,000

Consolidated Balance Sheet as on March 31, 2011

		(₹)
I	II. Equity and liabilities	
	(1) Shareholders' funds:	
	(a) Capital	50,00,000
	(b) Reserves and surplus	84,00,000
	(2) Minority Interest	13,75,000
	(3) Current liabilities	81,00,000
	TOTAL	2,28,75,000

II	Assets	
	(1) Non-current Assets	
	(a) Fixed assets:	
	Tangible asset	95,50,000
	Intangible asset	3,75,000
	(b) Non-current investments	60,00,000
	(2) Current assets	69,50,000
	TOTAL	2,28,75,000

Calculation of Profit/Loss on Disposal

Particulars	₹
Equity Share Capital of C Ltd.	10,00,000
Profit & Loss Account	45,00,000
Net Assets	55,00,000
45% of Net Asset	24,75,000
Less: Proceeds from Disposal	30,00,000
Profits	5,25,000
Less: Goodwill (3,75,000/75)x45	(2,25,000)
Profit on Sales of Investment	3,00,000

Calculation of Goodwill/Capital Reserve

Particulars	₹
Equity Share Capital of C Ltd.	10,00,000
Profit & Loss Account	45,00,000
Net Assets	55,00,000
30% of Net Asset	16,50,000
Less: Cost of investmnet ₹ (18,00,000 + 1,80,000)	(19,80,000)
Goodwill	3,30,000

Draft Consolidated Profit & Loss for the year ended on March 31, 2012

Particulars	₹	*Particulars*	₹	₹
		Balance b/d.		84,00,000
		Profits of A Ltd. ₹ (11,00,000 – 3,00,000)	8,00,000	
		Profits of B Ltd.	10,00,000	18,00,000
		Profits from Business Associates		1,80,000
Balance c/d	1,06,80,000	Profits from sale of Investment		3,00,000
	1,06,80,000			1,06,80,000

Consolidated Balance Sheet as on March 31, 2012

		(₹ in crores)
I	I. Equity and liabilities	
	(1) Shareholders' funds:	
	(a) Capital	50,00,000
	(b) Reserves and surplus	1,06,80,000
	(2) Current liabilities	55,00,000
	TOTAL	2,11,80,000
II	Assets	
	(1) Non-current Assets	
	(a) Fixed assets:	66,00,000
	(b) Non-current investments (Note 1)	39,80,000
	(2) Current assets	1,06,00,000
	TOTAL	2,11,80,000

Note to Accounts

1.	Non-current investments		
	Investment in C Ltd.	16,50,000	
	Add: Goodwill	3,30,000	19,80,000
	Other investment		20,00,000
			39,80,000

Reference: The students are advised to refer the full text of AS 23 "Accounting for Investments in Associates in Consolidated Financial Statements" (issued 2001).

UNIT 24 : AS 24: DISCONTINUING OPERATIONS

24.1 Introduction

AS 24, is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004 for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

In respect of all other enterprises, the Accounting Standard would be mandatory in nature in respect of accounting periods commencing on or after 1-4-2005. Earlier application of the accounting standard would be encouraged.

This standard is applicable to all discontinuing operations, representing separate major line of business or geographical area of operations of an enterprise.

24.2 Objective

The objective of this Statement is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

24.3 Discontinuing Operation

A discontinuing operation is a component of an enterprise:

a. That the enterprise, pursuant to a single plan, is:

   (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or

   (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or

   (iii) Terminating through abandonment and

b. That represents a separate major line of business or geographical area of operations.

c. That can be distinguished operationally and for financial reporting purposes.

A reportable business segment or geographical segment as defined in AS 17 'Segment Reporting', would normally satisfy criterion (b) of the above definition, that is, it would represent a separate major line of business or geographical area of operations. A part or such a segment may also satisfy criterion (b) of the above definition. For an enterprise that operates in a single business or geographical segment and, therefore, does not report segment information, a major product or service line may also satisfy the criteria of the definition.

The sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single co-ordinated plan.

An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not an abandonment because that operation, although changed, is continuing.

Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

a. Gradual or evolutionary phasing out of a product line or class of service.

b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.

c. Shifting of some production or marketing activities for a particular line of business from one location to another and

d. Closing of a facility to achieve productivity improvements or other cost savings.

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

A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

a. The operating assets and liabilities of the component can be directly attributed to it.

b. Its revenue can be directly attributed to it.

c. At least a majority of its operating expenses can be directly attributed to it.

Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it. Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.

24.4 Initial Disclosure Event

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation or

b. The enterprise's board of directors or similar governing body has both

   (i) approved a detailed, formal plan for the discontinuance and

   (ii) made an announcement of the plan.

a detailed, formal plan for the discontinuance normally includes:

- identification of the major assets to be disposed of;
- the expected method of disposal;
- the period expected to be required for completion of the disposal;
- the principal locations affected;
- the location, function, and approximate number or employees who will be compensated for terminating their services; and
- the estimated proceeds or salvage to be realised by disposal.

An enterprise’s board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, trade payables, trade unions, etc, in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

24.5 Recognition and Measurement

For recognizing and measuring the effect of discontinuing operations, this AS does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

24.6 Presentation and Disclosure

24.6.1 **Initial Disclosure :** An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

a. A description of the discontinuing operation(s).

b. The business or geographical segment(s) in which it is reported as per AS 17.

c. The date and nature of the initial disclosure event.

d. The date or period in which the discontinuance is expected to be completed if known or determinable.

e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled.

f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period.

g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

h. The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

24.6.2 Disclosures other than Initial Disclosures Note: All the disclosures above should be presented in the notes to the financial statements except for amounts pertaining to pre-tax profit/loss of the discontinuing operation and the income tax expense thereon (second last bullet above) which should be shown on the face of the statement of profit and loss.

Disclosures as required by AS 4 Contingencies and Events Occurring After the Balance Sheet Date, are made if an initial disclosure event occurs between the balance sheet date and the date on which the financial statements for that period are approved by the board of directors in the case of a company or by the corresponding approving authority in the case of any other enterprise.

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and

b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes. The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. A discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed. Any disclosures required by this Statement should be presented separately for each discontinuing operation.

The disclosures should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

a. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

b. The amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, Interim Financial Reporting, including:

a. Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and

b. Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

Reference: The students are advised to refer the full text of AS 24 “Discontinuing Operations” (issued 2002).

UNIT 25 : AS 25: INTERIM FINANCIAL REPORTING

25.1 Introduction

AS 25 does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement. The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, trade payables and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

A statute governing an enterprise or a regulator may also require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

25.2 Definitions of the terms used under the Accounting Standard

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.

During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period.

25.3 Content of an Interim Financial Report

A complete set of financial statements normally includes Balance sheet, Statement of Profit & Loss, Cash flow statement and Notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

The benefit of timeliness of presentation may be partially offset by a reduction in detail in the information provided. Therefore, this Statement requires preparation and presentation of an interim financial report containing, as a minimum, a set of condensed financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported. AS 25 does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. The recognition and measurement principles set out in this Statement apply also to complete financial statements for an interim period, and such statements would include all disclosures required by this Statement as well as those required by other Accounting Standards. Minimum Components of an Interim Financial Report includes condensed Financial Statement.

25.4 Form and Content of Interim Financial Statements

If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.

If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement.

Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.

If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with AS 20 then it has to present basic and diluted earnings per share as per AS 20 on the face of Statement of Profit and Loss complete or condenses for an interim period also.

25.5 Selected Explanatory Notes

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

a. A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change.

b. Explanatory comments about the seasonality of interim operations.

c. The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that is unusual because of their nature, size, or incidence as per AS 5.

d. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period.

e. Issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares.

f. Dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares.

g. Segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements).

h. The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations and

i. Material changes in contingent liabilities since the last annual balance sheet date.

The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

25.6 Periods for which Interim Financial Statements are required to be presented

Interim reports should include interim financial statements (whether condensed or complete) for the periods listed in the following table:

Statement	*Current*	*Comparative*
Balance sheet	End of current interim period	End of immediately preceding financial year
Statement of profit and loss	Current interim period and cumulatively for the year-to-date	Comparable interim period and year-to-date of immediately preceding financial year
Cash flow statement	Cumulatively for the current financial year-to-date	Comparable year-to-date of immediately preceding financial year

25.7 Materiality

In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data.

Illustration 1

Sincere Corporation is dealing in seasonal product sales pattern of the product, quarter wise is as follows:

1st quarter 30th June	*10%*
2nd quarter 30th September	*10%*

3rd quarter 31st December	*60%*
4th quarter 31st March	*20%*

Information regarding the 1st quarter ending on 30th June, 2012 is as follows:

Sales	*80 crores*
Salary and other expenses	*60 crores*
Advertisement expenses (routine)	*4 crores*
Administrative and selling expenses	*8 crores*

While preparing interim financial report for first quarter Sincere Corporation wants to defer ₹ 10 crores expenditure to third quarter on the argument that third quarter is having more sales therefore third quarter should be debited by more expenditure. Considering the seasonal nature of business and the expenditures are uniform throughout all quarters, calculate the result of the first quarter as per AS 25. Also give a comment on the company's view.

Solution

Particulars	(₹ In crores)	
Result of first quarter ending 30th June, 2012		
Turnover	80	
Other Income	Nil	
Total (a)		80
Less: Changes in inventories	Nil	
Salaries and other cost		60
Administrative and selling Expenses (4+8)		12
Total (b)		72
Profit (a)-(b)		8

According to AS 25 the Income and Expense should be recognized when they are earned and incurred respectively. Therefore seasonal incomes will be recognized when they occur. Thus the company's view is not as per AS 25.

Illustration 2

The accounting year of X Ltd. ends on 30th September, 2012 and it makes its reports quarterly. However for the purpose of tax, year ends on 31st March every year. For the Accounting year beginning on 1-10-2011 and ends on 30-9-2012, the quarterly income is as under:-

1st quarter ending on 31-12-2011	*₹ 200 crores*
2nd quarter ending on 31-3-2012	*₹ 200 crores*
3rd quarter ending on 30-6-2012	*₹ 200 crores*
4th quarter ending on 30-9-2012	*₹ 200 crores*
Total	*₹ 800 crores*

Average actual tax rate for the financial year ending on 31-3-2012 is 20% and for financial year ending 31-3-2013 is 30%. Calculate tax expense for each quarter.

Solution

Calculation of tax expense

1st quarter ending on 31-12-2011	200×20%	₹ 40 lakhs
2nd quarter ending on 31-3-2012	200×20%	₹ 40 lakhs
3rd quarter ending on 30-6-2012	200×30%	₹ 60 lakhs
4th quarter ending on 30-9-2012	200×30%	₹ 60 lakhs

25.8 Disclosure in Annual Financial Statements

AS 5, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Similarly, if an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

25.9 Accounting Policies

25.9.1 Same Accounting Policies as annual financial statements : An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

To illustrate:

a. The principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;

b. A cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and

c. Income tax expense is recognised in each interim period based on the best estimate of the weighted average annual effective income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual effective income tax rate changes.

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

25.9.2 Changes in Accounting Policies: Preparers of interim reports in compliance with AS 25 are required to consider any changes in accounting policies that will be applied for the next annual financial statements, and to implement the changes for interim reporting purposes.

If there has been any change in accounting policy since the most recent annual financial statements, the interim report is required to include a description of the nature and effect of the change.

25.10 Revenue Received Seasonally or Occasionally

Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

25.11 Cost Incurred Unevenly During the Financial Year

Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

A cost that does not meet the definition of an asset at the end of an interim period is not deferred in the interim balance sheet either to await future information as to whether it has met the definition of an asset, or to smooth earnings over interim periods within a financial year. Thus, when preparing interim financial statements, the enterprise’s usual recognition and measurement practices are followed. The only costs that are capitalized are those incurred after the specific point in time at which the criteria for recognition of the particular class of asset are met. Deferral of costs as assets in an interim balance sheet in the hope that the criteria will be met before the year-end is prohibited.

25.12 Use of Estimates

The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed.

25.13 Restatement of Previously Reported Interim Periods

One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle requires that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

25.14 Transitional Provision

On the first occasion that an interim financial report is presented in accordance with this Statement, the following need not be presented in respect of all the interim periods of the current financial year:

a. Comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and

b. Comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

25.15 Applicability of AS 25 to Interim Financial Results

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

25.16 Miscellaneous Illustrations

Illustration 3

Accountants of Poornima Ltd. show a net profit of ₹ 7,20,000 for the third quarter of 2011 after incorporating the following:

(i) Bad debts of ₹ 40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.

(ii) Extra ordinary loss of ₹ 35,000 incurred during the quarter has been fully recognized in this quarter.

(iii) Additional depreciation of ₹ 45,000 resulting from the change in the method of charge of depreciation assuming that ₹ 45,000 is the charge for the 3rd quarter only.

Ascertain the correct quarterly income.

Solution

In the above case, the quarterly income has not been correctly stated. As per AS 25 "Interim Financial Reporting", the quarterly income should be adjusted and restated as follows:

Bad debts of ₹ 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) ₹ 20,000 to the next quarter. Therefore, ₹ 20,000 should be deducted from ₹ 7,20,000. The treatment of extra-ordinary loss of ₹ 35,000 being recognized in the same quarter is correct.

Recognising additional depreciation of ₹ 45,000 in the same quarter is in tune with AS 25. Hence, no adjustments are required for these two items.

Poornima Ltd should report quarterly income as ₹ 7,00,000 (₹ 7,20,000–₹ 20,000).

Illustration 4

Intelligent Corporation (I–Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:

Quarter I	II	III	IV
Ending 31st March	30th June	30th September	31st December
15%-	15%-	50%-	-25%

For the First quarter ending 31st March, 2011, I–Corp. gives you the following information:

	₹ crores
Sales	50
Salary and other expenses	30
Advertisement expenses (routine)	02
Administrative and selling expenses	08

While preparing interim financial report for the first quarter 'I–Corp.' wants to defer ₹ 21 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore third quarter should be debited by higher expenditure, considering the seasonal nature of business. The expenditures are uniform throughout all quarters.

Calculate the result of first quarter as per AS 25 and comment on the company's view.

Solution

Result of the first quarter ended 31st March, 2011

			(₹ in crores)
Turnover			50
Add: Other Income			Nil
Total			50
Less: Change in inventories	Nil		
Salaries and other cost		30	
Administrative and selling expenses (8 + 2)	10		40
Profit			10

As per AS 25 on Interim Financial Reporting, the income and expense should be recognised when they are earned and incurred respectively. As per para 38 of AS 25, the costs should be anticipated or deferred only when

(i) it is appropriate to anticipate that type of cost at the end of the financial year, and

(ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of ₹ 21 crores is not tenable as expenditures are uniform through out all quarters.

Reference: The students are advised to refer the full text of AS-25 "Interim Financial Reporting": (issued 2002).

UNIT 26 : AS 26: INTANGIBLE ASSETS

26.1 Introduction

AS 26, comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. From the date of this Standard becoming mandatory for the concerned enterprises, AS 8; AS 6 & AS 10 stand withdrawn for the aspects relating to Intangible Assets.

The standard prescribes the accounting treatment for intangible assets that are not dealt with specifically under other accounting standards, and requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The standard specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

26.2 Scope

This standard should be applied by all enterprises in accounting intangible assets, except

(a) intangible assets that are covered by another AS,

(b) financial assets,

(c) rights and expenditure on the exploration for or development of minerals, oil, natural gas and similar non-regenerative resources,

(d) intangible assets arising in insurance enterprise from contracts with policy holders,

(e) expenditure in respect of termination benefits.

Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. This Statement also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

26.3 Definitions

An asset is a resource:

a. Controlled by an enterprise as a result of past events and

b. From which future economic benefits are expected to flow to the enterprise.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An active market is a market where all the following conditions exist:

a. The items traded within the market are homogeneous.

b. Willing buyers and sellers can normally be found at any time and

c. Prices are available to the public.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

A financial asset is any asset that is:

a. Cash,

b. A contractual right to receive cash or another financial asset from another enterprise,

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable or

d. An ownership interest in another enterprise.

26.4 Intangible Assets

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

The key components of the definition are:

- Identifiability; and
- Asset (the definition of which encompasses control).

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks. Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. If use of physical assets is possible only with the intangible part of it, we treat them as Fixed Assets like Operating system for computers. If physical element is just to support intangible part of it, we treat them as intangible assets.

26.5 Identifiability

The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity, though 'separability' is not a necessary condition for identifiability. If an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

26.6 Control

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality. Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise. As employees may quit the concern anytime or even loyal customers may decide to purchase goods and services from other suppliers. Moreover these items don't even qualify as intangible asset as per the definition given in this AS.

26.7 Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise.

26.8 Recognition and Initial Measurement of an Intangible Asset

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence and

b. The cost of the asset can be measured reliably.

These recognition criteria apply to both costs incurred to acquire an intangible asset and those incurred to generate an asset internally. However, the standard also imposes certain additional criteria for the recognition of internally-generated intangible assets.

When assessing the probability of expected future economic benefits, reasonable and supportable assumptions should be used, representing management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

An intangible asset should be measured initially at cost.

26.9 Separate Acquisition

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

26.10 Acquisition as Part of an Amalgamation

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14. In accordance with this Statement:

a. A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and

b. If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

26.11 Acquisition by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant.

This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

26.12 Internally Generated Intangible Assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into Research Phase & Development Phase. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

26.13 Research Phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

b. The search for, evaluation and final selection of, applications of research findings or other knowledge.

c. The search for alternatives for materials, devices, products, processes, systems or services;

d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

26.14 Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development or from the development phase should be recognised if, and only if, an enterprise can demonstrate all of the following:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. Its intention to complete the intangible asset and use or sell it.

c. Its ability to use or sell the intangible asset.

d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and

f. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of development activities are:

a. The design, construction and testing of pre-production or pre-use prototypes and models.

b. The design of tools, jigs, moulds and dies involving new technology.

c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and

d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

An enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets.

An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

This Statement takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

26.15 Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes, if applicable:

a. Expenditure on materials and services used or consumed in generating the intangible asset.

b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.

c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset and

d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

The following are not components of the cost of an internally generated intangible asset:

a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.

b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and

c. Expenditure on training the staff to operate the asset.

26.16 Items to be Recognised as an Expense

Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

a. It forms part of the cost of an intangible asset that meets the recognition criteria or

b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

AS 26 states that the following types of expenditure which should always be recognised as an an expense when it is incurred:

- Research;
- Start-up activities (start-up costs), unless the expenditure qualifies to be included in the cost of a tangible fixed asset. Start-up costs include:
- Preliminary expenses incurred in establishment of a legal entity; such as legal and secretarial costs;
- Expenditure to open a new facility or business (ie pre-opening costs); and
- Expenditure prior to starting new operations or launching new products or processes (ie

pre-operating costs);

- Training activities;
- Advertising and promotional activities; and
- Relocating or re-organising part or all of an enterprise.

It does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Expenses recognized as expenses cannot be reclassified as cost of Intangible Asset in later years.

26.17 Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and

b. The expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

26.18 Amortisation Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

a. Amortises the intangible asset over the best estimate of its useful life.

b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and

c. Discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

26.19 Amortisation Method

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

26.20 Residual Value

The residual value of an intangible asset should be assumed to be zero unless:

a. There is a commitment by a third party to purchase the asset at the end of its useful life or

b. There is an active market for the asset and:

   (i) Residual value can be determined by reference to that market and

   (ii) It is probable that such a market will exist at the end of the asset's useful life.

26.21 Review of Amortisation Period and Amortisation Method

During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. Therefore, the amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

26.22 Recoverability of the Carrying Amount-Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28, which will be discussed in the later units of this chapter. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under AS 28 and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition. In addition to the requirements of AS 28, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

a. An intangible asset that is not yet available for use and

b. An intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under AS 28 and impairment losses recognised accordingly.

If the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the required impairment test and makes the disclosure required.

26.23 Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

26.24 Disclosure

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

a. The useful lives or the amortisation rates used.

b. The amortisation methods used.

c. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.

d. A reconciliation of the carrying amount at the beginning and end of the period showing:

    i. Additions, indicating separately those from internal development and through amalgamation.

    ii. Retirements and disposals.

    iii. Impairment losses recognised in the statement of profit and loss during the period.

iv. Impairment losses reversed in the statement of profit and loss during the period.

v. Amortisation recognised during the period and

vi. Other changes in the carrying amount during the period.

The financial statements should also disclose:

a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.

b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.

c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and

d. The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

26.25 Transitional Provisions

Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under this Statement and the period determined has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined has not expired on the date of this Statement coming into effect and:

a. If the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

b. If the remaining period as per the accounting policy followed by the enterprise:

   (i) Is shorter as compared to the balance of the period determined, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

   (ii) Is longer as compared to the balance of the period determined, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

26.26 Illustrations

Illustration 1

Dell International Ltd. is developing a new production process. During the financial year 31st March, 2012, the total expenditure incurred on this process was ₹ 40 lakhs. The production process met the criteria for recognition as an intangible asset on 1st December, 2011. Expenditure incurred till this date was ₹ 16 lakhs.

Further expenditure incurred on the process for the financial year ending 31st March 2013, was ₹ 70 lakhs. As at 31-3-2013, the recoverable amount of know-how embodied in the process is estimated to be ₹ 62 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to work out:

(a) What is the expenditure to be charged to the profit and loss account for the financial year ended 31st March 2012? (Ignore depreciation for this purpose)

(b) What is the carrying amount of the intangible asset as at 31st March 2012?

(c) What is the expenditure to be charged to the profit and loss account for the financial year ended 31st March 2013? (Ignore depreciation for this purpose)

(d) What is the carrying amount of the intangible asset as at 31st March 2013?

Solution

(a) ₹ 22 lakhs

(b) Carrying amount as on 31-3-2012 will be expenditure incurred after 1-12-2011 = ₹ 24 lakhs

(c) Book cost of intangible asset as on 31-3-2013 is as follows

Total Book cost = ₹ (70 + 24) lakhs = ₹ 94 lakhs

Recoverable amount as estimated = ₹ 62 lakhs

Difference to be charged to Profit and Loss account = ₹ 32 lakhs

(d) ₹ 62 lakhs

Illustration 2

A Pharma Company spent ₹ 33 lakhs during the accounting year ended 31st March, 2012 on a research project to develop a drug to treat "AIDS". Experts are of the view that it may take four years to establish whether the drug will be effective or not and even if found effective it may take two to three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment.

Solution

As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. Thus the company cannot treat the expenditure as deferred revenue expenditure. The entire amount of ₹ 33 lakhs spent on research project should be charged as an expense in the year ended 31st March, 2012.

Illustration 3

Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at ₹ 10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be ₹ 36,00,000, ₹ 46,00,000, ₹ 44,00,000, ₹ 40,00,000 and ₹ 34,00,000. Find out the amortization cost of the patent for each of the years.

Solution

Swift Limited amortised ₹ 10,00,000 per annum for the first two years i.e. ₹ 20,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

Year	*Net cash flows* ₹	*Amortization Ratio*	*Amortization Amount* ₹
I	-	0.125	10,00,000[1]
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000
VII	34,00,000	0.170	10,20,000
Total	2,00,00,000	1.000	80,00,000

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 60,00,000 has been amortized in the ratio of net cash flows arising from the product of Swift Ltd.

Note*:* The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years.

Illustration 4

During 2011, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows:

	Amount (₹)

[1] It has been assumed that the company had amortized the patent at ₹ 10,00,000 per annum in the first two years on the basis of economic benefits derived from the product manufactured under the patent.

Completion of detailed programme and design	*25,000*
Coding and Testing	*20,000*
Other coding costs	*42,000*
Testing costs	*12,000*
Product masters for training materials	*13,000*
Duplication of computer software and training materials, from product masters (2,000 units)	*40,000*
Packing the product (1,000 units)	*11,000*

What amount should be capitalized as software costs in the books of the company, on Balance Sheet date?

Solution

As per para 44 of AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed programme design or working model. In this case, ₹ 45,000 would be recorded as an expense (₹ 25,000 for completion of detailed program design and ₹ 20,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (₹ 42,000 + ₹ 12,000 + ₹ 13,000) ₹ 67,000.

Reference: The students are advised to refer the full text of AS 26 "Intangible Assets" (issued 2002).

UNIT 27 : AS 27: FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

27.1 Introduction

AS 27, comes into effect in respect of accounting periods commencing on or after 01.04.2002. This standard set out principles and procedures for accounting of interests in joint venture and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors regardless of the structures or forms under which the joint venture activities take place. The standard deals with three broad types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities. The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, apply only when consolidated financial statements are prepared by venturer. Otherwise, AS 13 will be applicable in venturer's separate financial statements. An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23.

27.2 Scope

This Statement should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.

The provisions of this AS need to be referred to for consolidated financial statement only when CFS is prepared and presented by the venturer.

27.3 Definitions

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

From the above definition we conclude that the essential conditions for any business relation to qualify as joint venture are:

- **Two or more parties coming together:** Parties can be an individual or any form of business organization say, BOI, AOP, Company, firm.
- **Venturers undertake some economic activity:** Economic activity means activities with the profit-making motive. Joint venture is separate from the regular identity of the venturers, it may be in the form of independent and separate legal organization other than regular concern of the venturer engaged in the economic activity.
- **Venturers have joint control on the economic activity:** The operating and financial decisions are influenced by the venturers and they also share the results of the economic activity.

- **There exists a contractual agreement:** The relationship between venturers is governed by the contractual agreement. This agreement can be in the form of written and signed agreement or as minutes of venturer meeting or in any other written form.

Joint control is the contractually agreed sharing of control over an economic activity.

Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

A **venturer** is a party to a joint venture and has joint control over that joint venture.

An **investor** in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

27.4 Contractual Arrangement

The joint venture covered under this statement is governed on the basis of contractual agreement. Non-existence of contractual agreement will disqualify an organization to be covered in AS 27. Joint ventures with contractual agreement will be excluded from the scope of AS 23 only if the investment qualifies as subsidiary under AS 21, in this case, it will be covered by AS 21. Contractual agreement can be in the form of written contract, minutes of discussion between parties (venturers), articles of the concern or by-laws of the relevant joint venture.

Irrespective of the form of the contract, the content of the contract ideally should include the following points:

- The activity, duration and reporting obligations of the joint venture.
- The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers.
- Capital contributions by the venturers.
- The sharing by the venturers of the output, income, expenses or results of the joint venture.

The main object of contractual agreement is to distribute the economic control among the venturers, it ensures that no venturer should have unilateral control. If contractual agreement is signed by a party to safeguard its right, such agreement will not make the party a venturer. For example, IDBI gave loan to the joint venture entity of L&T and Tantia Construction, they signed an agreement according to which IDBI will be informed for all important decisions of the joint venture entity. This agreement is to protect the right of the IDBI, hence just signing the contractual agreement will not make investor a venturer. Similarly, just because contractual agreement has assigned the role of a manager to any of the venturer will not disqualify him as venturer. For example, Mr. A, M/s. B & Co. and C Ltd. entered into a joint venture, where according to the agreement, all the policies making decisions on financial and operating activities will be taken in a regular meeting attended by them or their representatives. Implementation and execution of these policies will be the responsibility of Mr. A. Here Mr. A is acting as venturer as well as manager of the concern.

27.5 Forms of Joint Ventures

Joint ventures may take many forms and structures, this Statement identifies them in three broad types - **Jointly Controlled Operations (JCO), Jointly Controlled Assets (JCA) and Jointly Controlled Entities (JCE).** Any structure which satisfies the following characteristics can be classified as joint ventures: (a) Two or more venturers are bound by a contractual arrangement and (b) The contractual arrangement establishes joint control.

27.6 Jointly Controlled Operations (JCO)

Under this set up, venturers do not create a separate entity for their joint venture business but they use their own resources for the purpose. They raise any funds required for joint venture on their own, they incur any expenses and sales are also realised individually. They use same set of fixed and employees for joint venture business and their own business. Since there is no separate legal entity and venturers don't recognize the transactions separately, they do not maintain a separate set of books for joint venture. All the transactions of joint venture are recorded in their books only. Following are the key features of JCO:

a. Each venturer has his own separate business.

b. There is no separate entity for joint venture business.

c. All venturers are creating their own assets and maintain them.

d. Each venturer record only his own transactions without any separately set of books maintained for the joint venture business.

e. There is a common agreement between all of them.

f. Venturers use their assets for the joint venture business.

g. Venturers met the liabilities created by them for the joint venture business.

h. Venturers met the expenses of the joint venture business from their funds.

i. Any revenue generated or income earned from the joint venture is shared by the venturers as per the contract.

Since the jointly controlled operation is not purchasing assets or raising finance in its own right, the assets and liabilities used in the activities of the joint venture are those of the ventures. As such, they are accounted for in the financial statements of the venture to which they belong. The only accounting issue that arises is that the output from the project is to be shared among the venturers and, therefore, there must be some mechanism for specifying the allocation of the proceeds and the sharing of any joint expenses.

Mr. A (dealer in tiles and marbles), Mr. B (dealer in various building materials) and Mr. C (Promoter) enters into a joint venture business, where any contract for construction received will be completed jointly, say, Mr. A will supply all tiles and marbles, Mr. B will supply other materials from his godown and Mr. C will look after the completion of construction. As per the contractual agreement, they will share any profit/loss in a predetermined ratio. None of them are using separate staff or other resources for the joint venture business and neither do they maintain a separate account. Every thing is recorded in their personal business only. Venturer doesn't maintain a separate set of books but they record only their own transactions of the joint venture business in their books. Any transaction of joint venture recorded separately is only for internal reporting purpose. Once all transactions recorded in venturer financial statement, they don't need to be adjusted for in consolidated financial adjustment.

Illustration 1

Mr. A, Mr. B and Mr. C entered into a joint venture to Purchase a land, Construct and Sell Flats. Mr. A purchased a land for ₹ 60,00,000 on 01.01.2011 and for the purpose he took loan from a bank for ₹ 50,00,000 @ 8% interest p.a. He also paid registering fees ₹ 60,000 on the same day. Mr. B supplied the materials for ₹ 4,50,000 from his godown and further he purchased the materials for ₹ 5,00,000 for the joint venture. Mr. C met all other expenses of advertising, labour and other incidental expenses which turnout to be ₹ 9,00,000. On 31.06.2011 each of the venturer agreed to take away one flat each to be valued at ₹ 10,00,000 each flat and rest were sold by them as follow: Mr. A for ₹ 40,00,000; Mr. B for ₹ 20,00,000 and Mr. C for ₹ 10,00,000. Loan was repaid on the same day by Mr. A alongwith the interest and net proceeds were shared by the partners equally.

You are required to prepare the draft Consolidated Profit & Loss Account and Joint Venture Account in the books of each venturer.

Solution

Draft Consolidated Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Purchase of Land:			By Sale of Flats:		
Mr. A		60,00,000	Mr. A	40,00,000	
To Registration Fees:			Mr. B	20,00,000	
Mr. A		60,000	Mr. C	10,00,000	70,00,000
To Materials:			By Flats taken by Venturers:		
Mr. B		9,50,000	Mr. A	10,00,000	
To Other Expenses:			Mr. B	10,00,000	
Mr. C		9,00,000	Mr. C	10,00,000	30,00,000
To Bank Interest:					
Mr. A		2,00,000			
To Profits:					
Mr. A	6,30,000				
Mr. B	6,30,000				
Mr. C	6,30,000	18,90,000			
		1,00,00,000			1,00,00,000

In the Books of Mr. A
Joint Venture Account

Particulars	₹	*Particulars*	₹
To Bank Loan (Purchase of Land)	50,00,000	By Bank (Sale of Flats)	40,00,000

To Bank:(Purchase of Land)	10,00,000	By Land & Buidling	10,00,000
To Bank (Registration Fees)	60,000	By Bank (Paid to Mr. B)	14,20,000
To Bank (Bank Interest)	2,00,000	By Bank (Paid to Mr.C)	4,70,000
To Profit on JV	6,30,000		
	68,90,000		68,90,000

In the Books of Mr. B
Joint Venture Account

Particulars	₹	*Particulars*	₹
To Purchases (Material Supplied)	4,50,000	By Bank (Sale of Flats)	20,00,000
To Bank (Materials)	5,00,000	By Land & Buidling	10,00,000
To Profit on JV	6,30,000		
To Bank (Received from Mr. A)	14,20,000		
	30,00,000		30,00,000

In the Books of Mr. C
Joint Venture Account

Particulars	₹	*Particulars*	₹
To Bank (Misc. Expenses)	9,00,000	By Bank (Sale of Flats)	10,00,000
To Profit on JV	6,30,000	By Land & Buidling	10,00,000
To Bank (Received from Mr. A)	4,70,000		
	20,00,000		20,00,000

27.7 Jointly Controlled Assets (JCA)

Separate legal entity is not created in this form of joint venture but venturer owns the assets jointly, which are used by them for the purpose of generating economic benefit to each of them. They take up any expenses and liabilities related to the joint assets as per the contract. We can conclude the following points:

- There is no separate legal identity.
- There is a common control over the joint assets.
- Venturers use this asset to derive some economic benefit to themselves.
- Each venturer incurs separate expenses for their transactions.
- Expenses on jointly held assets are shared by the venturers as per the contract.
- In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.
- Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated

financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

- Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

For example, ABC Ltd., BP Ltd. and HP Ltd. having the same point of oil refinery and same place of customers agreed to spread a pipeline from their unit to customers place jointly. They agreed to share the expenditure on the pipeline construction and maintenance in the ratio 3:3:4 respectively and the time allotted to use the pipeline was in the ratio 4:3:3 respectively.

For the joint venture, each venturer will record his share of joint assets as per AS 10, Accounting for Fixed Assets, and any expenditure incurred or revenue generated will be recorded with other items similar to JCO. Following are the few differences between JCO and JCA for better understanding:

- In JCO venturers uses their own assets for joint venture business but in JCA they jointly owns the assets to be used in joint venture.
- JCO is an agreement to joint carry on the operations to earn income whereas, JCA is an agreement to jointly construct and maintain an asset to generate revenue to each venturer.
- Under JCO all expenses and revenues are shared at an agreed ratio, in JCA only expenses on joint assets are shared at the agreed ratio.

Illustration 2

A Ltd., B Ltd. and C Ltd. decided to jointly construct a pipeline to transport the gas from one place to another that was manufactured by them. For the purpose following expenditure was incurred by them: Buildings ₹ 12,00,000 to be depreciated @ 5% p.a., Pipeline for ₹ 60,00,000 to be depreciated @ 15% p.a., computers and other electronics for ₹ 3,00,000 to be depreciated @ 40% p.a. and various vehicles of ₹ 9,00,000 to be depreciated @ 20% p.a.

They also decided to equally bear the total expenditure incurred on the maintainence of the pipeline that comes to ₹ 6,00,000 each year.

You are required to show the consolidated financial balance sheet and the extract of draft Profit & Loss Account and Balance Sheet for each venturer.

Solution

Consolidated Balance Sheet

		Note	(₹)
I	Equity and liabilities		
	Shareholders' funds:		
	Share Capital	1	77,40,000
	TOTAL		77,40,000

II	Assets		
	Non-current Assets		
	Fixed assets:		
	Tangible assets	2	77,40,000
			77,40,000

Notes to Accounts

1.	Share capital		
	A Ltd.	2,580,000	
	B Ltd.	2,580,000	
	C Ltd.	2,580,000	7,740,000
2.	Tangible assets		
	Land & Building:		
	A Ltd.	380,000	
	B Ltd.	380,000	
	C Ltd.	380,000	1,140,000
	Plant & Machinery:		
	A Ltd.	1,900,000	
	B Ltd.	1,900,000	
	C Ltd.	1,900,000	5,700,000
	Computers:		
	A Ltd.	60,000	
	B Ltd.	60,000	
	C Ltd.	60,000	180,000
	Vehicles:		
	A Ltd.	240,000	
	B Ltd.	240,000	
	C Ltd.	240,000	720,000

In the Books of A Ltd.

Extract of draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	*1*	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	380,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	1,700,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	240,000
			23,80,000

In the Books of B Ltd.
Extract of draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	*1*	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	

	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

In the Books of C Ltd.

Extract of Draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	1	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

27.8 Jointly Controlled Entities (JCE)

This is the format where venturer creates a new entity for their joint venture business. All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity. The net result of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement. This contractual agreement also determines the joint control of the venturer.

Being a separate entity, separate set of books is maintained for the joint venture and in the individual books of venturers the investment in joint venture is recorded as investment (AS 13). Joint venture can be a foreign company operating in India through an Indian concern say Gremo Insurance of Germany contributes 49% of the assets in joint venture in India with Indo Bank Ltd. of India. They agreed to share the net results in 1:1 ratio. The main objective of the joint venture is to exploits the technical expertise of Gremo Insurance and Goodwill of Indo Bank Ltd. It can also be two or more local concerns opening an organization or firm or company contributing their assets to this new joint venture concern and share the profits of the operation in the agreed ratio.

Illustration 3

A Ltd. a UK based company entered into a joint venture with B Ltd. in India, wherein B Ltd. will sell import the goods manufactured by A Ltd. on account of joint venture and sell them in India. A Ltd. and B Ltd. agreed to share the expenses & revenues in the ratio of 5:4 respectively whereas profits are distributed equally. A Ltd. invested 49% of total capital but has equal share in all the assets and is equally liable for all the liabilities of the joint venture. Following is the trail balance of the joint venture at the end of the first year:

Particulars	*Dr. (₹)*	*Cr.(₹)*
Purchases	*9,00,000*	
Other Expenses	*3,06,000*	
Sales		*13,05,000*
Fixed Assets	*6,00,000*	
Current Assets	*2,00,000*	
Unsecured Loans		*2,00,000*
Current Liabilities		*1,00,000*
Capital		*4,01,000*

Closing inventory was valued at ₹1,00,000.

You are required to prepare the Consolidated Financial Statement.

Solution

Consolidated Profit & Loss Account

Particulars	*Note No.*	*(₹)*
Revenue from operations	1	13,05,000
Total Revenu (A)		13,05,000
Less: Expenses		
Purchases	2	9,00,000

Other expenses	3	3,06,000
Changes in inventories of finished goods	4	(1,00,000)
Total Expenses (B)		11,06,000
Profit Before Tax (A-B)		1,99,000

Consolidated Balance Sheet

		Note No.	(₹)
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital	5	4,01,000
	Reserves and Surplus	6	1,99,000
	2. Non-current liabilities		
	Long term borrowings	7	2,00,000
	3. Current Liabilities	8	1,00,000
	TOTAL		9,00,000
II	Assets		
	Non-current Assets		
	Fixed assets:	9	6,00,000
	Current Assets		
	Inventories	10	1,00,000
	Other current assets	11	2,00,000
			9,00,000

Notes to Accounts

	Particulars		(₹)
1.	Revenue from operations		
	Sales:		
	A Ltd.	7,25,000	
	B Ltd.	5,80,000	13,05,000
2.	Purchases		
	A Ltd.	5,00,000	
	B Ltd.	4,00,000	9,00,000
3.	Other expenses		
	A Ltd.	1,70,000	
	B Ltd.	1,36,000	3,06,000
4.	Closing Inventory		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
5.	Share Capital:		

	A Ltd.	1,96,490	
	B Ltd.	2,04,510	4,01,000
6.	Reserves and Surplus		
	Profit & Loss Account:		
	A Ltd.	99,500	
	B Ltd.	99,500	1,99,000
7.	Long Term Borrowings		
	Unsecured Loans:		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000
8.	Current Liabilities:		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
9.	Fixed Assets:		
	A Ltd.	3,00,000	
	B Ltd.	3,00,000	6,00,000
10.	Inventories		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
11.	Other Current Assets:		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000

27.9 Consolidated Financial Statements of a Venturer

Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Proportionate consolidation method of accounting is to be followed except in the following cases:

a. Investment is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

b. The term 'Near Future' is explained with AS 21.

   Or joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

   In both the above cases, investment of venturer in the share of the investee is treated as investment according to AS 13.

A venturer should discontinue the use of the proportionate consolidation method from the date that:

a. It ceases to have joint control in the joint venture but retains, either in whole or in part, its investment.

b. The use of the proportionate consolidation method is no longer appropriate because the joint venture operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturers.

From the date of discontinuing the use of the proportionate consolidation method,

a. If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statement.

b. Joint ventures where interest is 20% or more but less than 51%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statement.

c. For all other cases investment in joint venture is treated as per AS 13, Accounting for Investment.

d. For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

Following are the features of Proportionate Consolidation Method:

a. Stress is given on substance over form i.e., more importance is given to the share of venturers in the profit or loss of the venture from the share of assets and liabilities rather than the nature and form of the joint venture.

b. Venturer's share of joint assets, liabilities, expenses and income are shown on the separate lines in the consolidated financial statement.

   For example, Mr. A enters into a joint venture with Mr. B and has contributed 33% of the total fixed assets and has share of 40% in current assets and current liabilities. Its share in net result is 50%. Consolidated Balance Sheet will be prepared by Mr. A as follow:

Consolidated Balance Sheet

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital	1	1,00,000
	2. Current Liabilities	2	50,000
	TOTAL		1,50,000
II	Assets		
	Non-current Assets		
	Fixed assets:	3	75,000
	Current Assets	4	75,000
			1,50,000

Notes to Accounts

1.	Share Capital:		
	A	33,000	
	B	67,000	1,00,000
2.	Current Liabilities:		
	A	20,000	
	B	30,000	50,000
3.	Fixed Assets:		
	A	25,000	
	B	50,000	75,000
4.	Current Assets:		
	A	30,000	
	B	45,000	75,000

Similar to above all the items of expenses and income will also be classified line by line for each item. The whole basis of this provision is to bring transparency in the books of account. If there is any special clause for sharing of expenses, income or any other item that should be clearly disclosed in the consolidated financial statement.

c. Most of the provisions of Proportionate Consolidation Method are similar to the provisions of AS 21.

d. As far as possible the reporting date of the financial statements of jointly controlled entity and venturers should be same. If practically it is not possible to draw up the financial statements to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made in joint venturer's books for the effects of significant transactions or other events that occur between the jointly controlled entity's date and the date of the venturer's financial statements. In any case, the difference between reporting dates should not be more than six months.

e. Accounting policies followed in the preparation of the financial statements of the jointly controlled entity and venturer should be uniform for like transactions and other events in similar circumstances.

   If accounting policies followed by venturer and jointly controlled entity are not uniform, then adjustments should be made in the items of the venturer to bring it in line with the accounting policy of the joint venture.

f. Any asset or liability should not be adjusted by another liability or asset. Similarly any income or expense cannot be adjusted with another expense or income. Such adjustment can be made only when legally it is allowed to adjust them and such items does lead to settlement of obligation or writing off of assets.

g. On the date when interest in joint entity is acquired, if the interest of venturer in net assets of the entity is less than the cost of investment in joint entity, the difference will be recognized as goodwill in the consolidated financial statement and if net asset is more than cost of investment, then the difference is recognized as capital reserve.

In case the carrying amount of investment is different then cost of investment, we take carrying amount for the purpose of the above calculation.

h. An investor who don't have joint control in the entity is like associate as discussed in AS 23, therefore the treatment of losses will be similar to AS 23. If investor's share in loss of the joint entity is in excess of his interest in net asset, this excess loss will be recognized by the venturers. In future when entity starts reporting profits, investor's share of profits will be provided to venturer till total amount is equivalent to absorbed losses.

Illustration 4

A Ltd. entered into a joint venture with B Ltd. on 1:1 basis and a new company C Ltd. was formed for the same purpose and following is the balance sheet of all the three companies:

Particulars	*A Ltd.*	*B Ltd.*	*C Ltd.*
Share Capital	*1,000,000*	*750,000*	*500,000*
Reserve & Surplus	*1,800,000*	*1,600,000*	*1,200,000*
Loans	*300,000*	*400,000*	*200,000*
Current Liabilities	*400,000*	*250,000*	*100,000*
Fixed Assets	*3,050,000*	*2,625,000*	*1,950,000*
Investment in JV	*250,000*	*250,000*	*-*
Current Assets	*200,000*	*125,000*	*50,000*

Prepare the balance sheet of A Ltd., B Ltd. and C Ltd. under proportionate consolidation method.

Solution

Balance Sheet of A Ltd.

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital		10,00,000
	Reserves and Surplus	1	24,00,000
	2. Non-current liabilities	2	4,00,000
	3. Current Liabilities	3	4,50,000
	TOTAL		42,50,000
II	Assets		
	Non-current Assets		
	Fixed assets:	4	40,25,000
	Current Assets	5	2,25,000
			42,50,000

Notes to Accounts

1.	Reserves and Surplus		
	A Ltd.	18,00,000	
	C Ltd.	6,00,000	24,00,000
2.	Long Term Borrowings		
	Loans:		
	A Ltd.	3,00,000	
	C Ltd.	1,00,000	4,00,000
3.	Current Liabilities:		
	A Ltd.	4,00,000	
	C Ltd.	50,000	4,50,000
4.	Fixed Assets:		
	A Ltd.	30,50,000	
	C Ltd.	9,75,000	40,25,000
5.	Current Assets:		
	A Ltd.	2,00,000	
	C Ltd.	25,000	2,25,000

Balance Sheet of B Ltd.

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital		7,50,000
	Reserves and Surplus	1	22,00,000
	2. Non-current liabilities	2	5,00,000
	3. Current Liabilities	3	3,00,000
	TOTAL		37,50,000
II	Assets		
	Non-current Assets		
	Fixed assets:	4	36,00,000
	Current Assets	5	1,50,000
			37,50,000

Notes to Accounts

1.	Reserves and Surplus		
	A Ltd.	16,00,000	
	C Ltd.	6,00,000	22,00,000
2.	Long Term Borrowings		
	Loans:		
	A Ltd.	4,00,000	
	C Ltd.	1,00,000	5,00,000

3.	Current Liabilities:		
	A Ltd.	2,50,000	
	C Ltd.	50,000	3,00,000
4.	Fixed Assets:		
	A Ltd.	26,25,000	
	C Ltd.	9,75,000	36,00,000
5.	Current Assets:		
	A Ltd.	1,25,000	
	C Ltd.	25,000	1,50,000

27.10 Transactions between a Venturer and Joint Venture

When venturer transfers or sells assets to Joint Venture, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss only when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

When the venturer from the joint venture purchases the assets, venturer will not recognized his share of profits in the joint venture of such transaction unless he disposes off the assets. A venturer should recognise his share of the losses resulting from these transactions in the same way as profits except that losses will be recognised in full immediately only when they represent a reduction in the net realisable value of current assets or an impairment loss.

In case the joint venture is in the form of separate entity then provisions of above the Para will be followed only for consolidated financial statement and not for venturer's own financial statement. In the books of venturer, profit or loss from such transactions are recognised in full.

27.11 Reporting Interests in Joint Ventures in the Financial Statements of an Investor

The investors who don't have joint control over the entity recognized his share of net results and his investments in joint venture as per AS 13. In the consolidated financial statement it is recognized as per AS 13, AS 21 or AS 23 as appropriate.

27.12 Operators of Joint Ventures

Payment to operators is recognized as expense in CFS and in the books of the operators as per AS 9, Revenue Recognition. The operator may any of the venturer, in this case any amount received by him, as management fees for the service will be recognized as stated above in this Para.

27.13 Disclosures

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

a. Any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

b. Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

c. Those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

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

a. Any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

b. Its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

Reference: The students are advised to refer the full text of AS 27 "Financial Reporting of Interests in Joint Ventures" (issued 2002).

UNIT 28 : AS 28: IMPAIRMENT OF ASSETS

28.1 Introduction

AS 28 came into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of accounting periods commencing on or after 1-4-2005 and is mandatory in nature from that date.

This standard prescribes the procedures to be applied to ensure that the assets of an enterprise are carried at an amount not exceeding their recoverable amount (amount to be recovered through use or sale of the asset). The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets. An enterprise is required to assess at each balance sheet date whether there is an indication that an enterprise may be impaired. If such an indication exists, the enterprise is required to estimate the recoverable amount and the impairment loss, if any, should be recognised in the profit and loss account.

28.2 Scope

The standard should be applied in accounting for impairment of all assets except

1. inventories (AS 2),
2. assets arising under construction contracts (AS 7),
3. financial assets including investments covered under AS 13, and deferred tax assets (AS 22).

There are chances that the provision on account of impairment losses may increase sickness of companies and potentially sick companies may actually become sick.

Therefore, AS 28 applies to (among other assets):

- Land and buildings;
- Plant and machinery;
- Investment property;
- Intangible assets;
- Goodwill;
- Assets carried at revalued amounts under AS 10.

28.3 Assessment

An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

External sources of information

a. During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

b. Significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated.

c. Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

d. The carrying amount of the net assets of the reporting enterprise is more than its market capitalization.

Internal sources of information

a. Evidence is available of obsolescence or physical damage of an asset.

b. Significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date and

c. Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated.

If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard 6, even if no impairment loss is recognised for the asset.

28.4 Measurement of Recoverable Amount

Recoverable amount for an asset is defined by the statement as the higher of net selling price or value of use. If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for an asset that is held for disposal. Otherwise, if it is not possible to determine the selling price we take value in use of assets as it's recoverable amount.

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs, unless either:

a. The asset's net selling price is higher than its carrying amount; or

b. The asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

The best evidence for net selling price is a price in the bidding sales agreement for the disposal of the assets or similar assets. In the absence of this net selling price is estimated from the transactions for the assets in active market, if the asset has the active market. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

Value in Use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Estimating the value in use of an asset involves the following steps:

a. Estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and

b. Applying the appropriate discount rate to these future cash flows.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount

Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

Depreciation (Amortisation) is a systematic allocation of the depreciable amount of an asset over its usefull life.

Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Useful life is either:

- The period of time over which an asset is expected to be used by the enterprise; or

- The number of production or similar units expected to be obtained from the asset by the enterprise.

28.5 Basis for Estimates of Future Cash Flows

Cash flow projections should be based on the most recent budgets/forecasts for a maximum of five years. Financial budgets/forecasts over a period longer than five years may be used if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

Cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence.

28.6 Composition of Estimates of Future Cash Flows

Estimates of future cash flows should include (i) Projections of net cash inflows from the continuing use of the asset and (ii) Net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Care should be taken for the following points:

a. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale should be included.

b. Cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review should not be included.

c. Cash outflows that relate to obligations that have already been recognised as liabilities to be excluded.

d. Future cash outflows or inflows expected to arise because of restructuring of the organization should be not considered.

e. Any future capital expenditure enhancing the capacity of the assets should be excluded.

f. Any increase in expected cash inflow from the above expenditure should also be excluded.

g. Estimates of future cash flows should not include cash inflows or outflows from financing activities and also income tax receipts or payments.

Foreign Currency Future Cash Flows are estimated in the currency it will be generated and after they are discounted for the time value of money, we convert them in the reporting currency on the basis of AS 11.

Discount Rate

The discount rate(s) should be a pre tax rate(s) that reflect(s) current market assessme nts of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset.

28.7 Recognition and Measurement of an Impairment Loss

If recoverable amount of assets more than carrying amount, we ignore the difference and asset is carried on at the same book value. But when this recoverable amount is less than the carrying amount, this difference termed as Impairment Loss should be written off immediately as expenses to Profit & Loss Account. If assets are carried out at revalued figures then the impairment loss equivalent to revalued surplus is adjusted with it and the balance (if any) is charged to Profit & Loss Account. Depreciation for the coming years on the assets are recalculated on the basis new carrying amount, residual value and remaining useful life of the asset, according to AS 6.

28.8 Identification of the Cash-Generating Unit to which an Asset Belongs

A *cash generating unit* is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset, if it is not possible to estimate the recoverable amount of the individual asset because the value in use of the asset cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the asset belongs.

If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise, this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output. Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

28.9 Recoverable Amount and Carrying Amount of a Cash-Generating Unit

The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined i.e. carrying amount is the summation of the carrying amount of all the assets grouped under one cash-generating unit. This also includes the liability only if that liability is necessary to be considered to determine the recovery amount. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount. For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit or liabilities that have already been recognised in the financial statements. In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

28.10 Goodwill

Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs. This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognized. If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test

28.11 Corporate Assets

Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review. For each identified corporate asset:

a. If the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and

b. If the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom-up' and 'top-down' tests.

28.12 Impairment Loss for a Cash-Generating Unit

The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

a. First, to goodwill allocated to the cash-generating unit (if any); and

b. Then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets

The carrying amount of an asset should not be reduced below the highest of:

a. Its net selling price (if determinable);

b. Its value in use (if determinable); and

c. Zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

28.13 Reversal of an Impairment Loss

An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss. Indications of a potential decrease in an impairment loss are mainly mirror the indications of a potential impairment loss discussed above as external and internal indicators. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

28.14 Reversal of an Impairment Loss for an Individual Asset

If impairment loss was written off to profit and loss account, then the reversal of impairment loss should be recognized as income in the financial statement immediately. If impairment loss was adjusted with the Revaluation Reserve as per AS 10; then reversal of impoairment loss will be written back to the reserve account to the extent it was adjusted, any surplus will be recognised as revenue. But in any case the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods. This is mainly because any further increase in value of asset is revaluation, which is governed by AS 10.

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

28.15 Reversal of an Impairment Loss for a Cash-Generating Unit

A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

a. First, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and

b. Then, to goodwill allocated to the cash-generating unit (if any),

28.16 Reversal of an Impairment Loss for Goodwill

This Statement does not permit an impairment loss to be reversed for goodwill because of a change in estimates, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

a. The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and

b. Subsequent external events have occurred that reverse the effect of that event.

28.17 Impairment in case of Discontinuing Operations

In applying this Statement to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit. For example:

a. If the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation. Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Statement;

b. If the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and

c. If the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

28.18 Disclosure

For each class of assets, the financial statements should disclose:

a. The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

b. The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

c. The amount of impairment losses recognised directly against revaluation surplus during the period; and

d. The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

a. The amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and

b. The amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

a. The events and circumstances that led to the recognition or reversal of the impairment loss;

b. The amount of the impairment loss recognised or reversed;

c. For an individual asset:

   (i) The nature of the asset; and

   (ii) The reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);

d. For a cash-generating unit:

   (i) A description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);

   (ii) The amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and

   (iii) If the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;

e. Whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

f. If recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

g. If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

a. The main classes of assets affected by impairment losses (reversals of impairment losses);

b. The main events and circumstances that led to the recognition (reversal) of these impairment losses.

28.19 Transitional Provisions

On the date of this Statement becoming mandatory, an enterprise should assess whether there is any indication that an asset may be impaired (see paragraphs 5-13). If any such indication exists, the enterprise should determine impairment loss, if any, in accordance with this Statement. The impairment loss, so determined, should be adjusted against opening balance of revenue reserves being the accumulated impairment loss relating to periods prior to this Statement becoming mandatory unless the impairment loss is on a revalued asset. An impairment loss on a revalued asset should be recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. If the impairment loss exceeds the amount held in the revaluation surplus for that same asset, the excess should be adjusted against opening balance of revenue reserves. Any impairment loss arising after the date of this Statement becoming mandatory should be recognised in accordance with this Statement (i.e., in the statement of profit and loss unless an asset is carried at revalued amount. An impairment loss on a revalued asset should be treated as a revaluation decrease).

28.20 Illustrations

Illustration 1

Ergo Industries Ltd. gives the following estimates of cash flows relating to fixed asset on 31-12-2010. The discount is 15%.

Year	*Cash Flow (₹ In lakhs)*
2011	*4000*
2012	*6000*
2013	*6000*
2014	*8000*
2015	*4000*

Residual value at the end of 2015	=	*₹ 1000 lakhs*
Fixed Asset purchased on 1-1-2008	=	*₹ 40,000 lakhs*
Useful life	=	*8 years*
Net selling price on 31-12-2015	=	*₹ 20,000 lakhs*

Calculate on 31-12-2010:

(a) Carrying amount at the end of 2010

(b) Value in use on 31-12-2010

(c) Recoverable amount on 31-12-2010

(d) Impairment loss to be recognized for the year ended 31-12-2010

(e) Revised carrying amount

(f) Depreciation charge for 2011

Solution

Calculation of value in use

Year	*Cash Flow*	*Discount as per 15%*	*Discounted cash flow*
2011	4,000	0.870	3,480
2012	6,000	0.756	4,536
2013	6,000	0.658	3,948
2014	8,000	0.572	4,576
2015	4,000	0.497	1,988
2015	(residual) 1,000	0.497	497
			19,025

Value in use = ₹ 19,025 lakhs

Net Selling Price = ₹ 20,000 lakhs

Recoverable amount = higher of value in use and net selling price i.e. ₹ 20,000 lakhs.

Calculation of carrying amount:

Original cost = ₹ 40,000 lakhs

Depreciation for 3 years = [(40,000-1000)×3/8] = ₹ 14,625

Carrying amount on 31-12-2010 = [40,000-14,625] = ₹ 25,375

Recoverable amount = ₹ 20,000 lakhs

Impairment Loss = ₹ (25,375-20,000) = ₹ 5,375 lakhs

Revised carrying amount = ₹ (25,375-5,375) = ₹ 20,000 lakhs

Depreciation Charge for 2011 = (20,000-1000)/5 = ₹ 3,800

Illustration 2

X Ltd. is having a plant (asset) carrying amount of which is ₹ 100 lakhs on 31.3.2004. Its balance useful life is 5 years and residual value at the end of 5 years is ₹ 5 lakhs. Estimated future cash flow from using the plant in next 5 years are:-

For the year ended on	*Estimated cash flow (₹ in lakhs)*
31.3.2011	50
31.3.2012	30
31.3.2013	30
31.3.2014	20
31.3.2015	20

Calculate "value in use" for plant if the discount rate is 10% and also calculate the recoverable amount if net selling price of plant on 31.3.2010 is ₹ 60 lakhs.

Solution

Present value of future cash flow

Year ended	*Future Cash Flow*	*Discount @ 10% Rate*	*Discounted cash flow*
31.3.2011	50	0.909	45.45
31.3.2012	30	0.826	24.78
31.3.2013	30	0.751	22.53
31.3.2014	20	0.683	13.66
31.3.2015	20	0.620	12.40
			118.82
Present value of residual price on 31.3.2015 = 5 $\times$ 0.620			3.10
Present value of estimated cash flow by use of an asset and residual value, which is called "value in use".			121.92

If net selling price of plant on 31.3.2010 is ₹ 60 lakhs, the recoverable amount will be higher of ₹ 121.92 lakhs (value in use) and ₹ 60 lakhs (net selling price), hence recoverable amount is ₹ 121.92 lakhs

Reference: The students are advised to refer the full text of AS 28 "Impairment of Assets" (issued 2002).

UNIT 29 : AS 29 : PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

29.1 Introduction

AS 29 comes into effect in respect of accounting periods commencing on or after 1-4-2004. The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. This standard applies in accounting for provisions and contingent liabilities and contingent assets resulting from financial instruments (not carried at fair value) and insurance enterprises (other than those arising from contracts with policyholders).

The standard will not apply to provisions/liabilities resulting from executor contracts and those covered under any other accounting standard.

This Standard is mandatory in nature from that date:

a. In its entirety, for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

   i. Enterprises whose equity or debt securities are listed whether in India or outside India.

   ii. Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

   iii. Banks including co-operative banks.

   iv. Financial institutions.

   v. Enterprises carrying on insurance business.

   vi. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 50 crore. Turnover does not include 'other income'.

   vii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 10 crore at any time during the accounting period.

   viii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

b. In its entirety, except paragraph 67, for the enterprises which do not fall in any of the categories in (a) above but fall in any one or more of the following categories:

   i. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 40 lakhs but does not exceed ₹ 50 crore. Turnover does not include 'other income'.

   ii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 1 crore but not in excess of ₹ 10 crore at any time during the accounting period.

   iii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

c. In its entirety, except paragraphs 66 and 67, for the enterprises, which do not fall in any of the categories in (a) and (b) above.

Where an enterprise has been covered in any one or more of the categories in (a) above and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from paragraph 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) above for two consecutive years.

Where an enterprise has been covered in any one or more of the categories in (a) or (b) above and subsequently, ceases to be covered in any of the categories in (a) and (b) above, the enterprise will not qualify for exemption from paragraphs 66 and 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) and (b) above for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, but no longer qualifies for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, in the current accounting period, this Standard becomes applicable, in its entirety or, in its entirety except paragraph 67, as the case may be, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraph 67 or paragraphs 66 and 67, as the case may be, should disclose the fact.

29.2 Scope

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

a. Those resulting from financial instruments that are carried at fair value;

b. Those resulting from executory contracts;

c. Those arising in insurance enterprises from contracts with policy-holders; and

d. Those covered by another Accounting Standard.

Where another Accounting Standard like 7; 9; 15; 19; 22 & 24 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement.

29.3 Definitions

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

Examples of executory contracts include:

- Employee contracts in respect of continuing employment;
- Contracts for future delivery of services such as gas and electricity;
- Obligations to pay local authority charges and similar levies; and
- Most purchase orders.

A **Provision** is a liability which can be measured only by using a substantial degree of estimation.

A **Liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An **Obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A Contingent liability is:

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

(b) A present obligation that arises from past events but is not recognised because:

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

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

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

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

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

A **Restructuring** is a programme that is planned and controlled by management, and materially changes either:

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

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

29.4 Provisions

A provision should be recognised when:

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

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

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

If these conditions are not met, no provision should be recognised.

29.5 Present Obligation

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence. On the basis of such evidence:

(a) Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

29.6 Past Event

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

29.7 Probable Outflow of Resources Embodying Economic Benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

29.8 Reliable Estimate of the Obligation

The use of estimates is an inherent part of preparing financial statements. Provisions require a greater degree of estimation than most other items, but AS 29 emphasises that it should not be impossible to determine a range of possible outcomes and, from this range, to reach an appropriate conclusion that is sufficiently reliable for the provision to be recognised. AS 29 concludes that the circumstances in which it will not be possible to reach a reliable estimate, will be extremely rare.

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability will, instead, be disclosed as a contingent liability.

29.9 Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

29.10 Contingent Assets

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority.

29.11 Measurement -Best Estimate

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The amount of a provision should not be discounted to its present value. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

29.12 Future Events

It is only those obligations arising from past events that exist independently of the enterprise's future actions (ie the future conduct of its business) that are recognised as provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

29.13 Expected Disposal of Assets

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

29.14 Reimbursements

An, enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via:

- An insurance contract arranged to cover a risk;
- An indemnity clause in a contract; or
- A warranty provided by a supplier.

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Consequently, such a reimbursement should be recognised only when it is virtually certain that it will be received consequent upon the settlement of the obligation.

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

29.15 Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

29.16 Use of Provisions

Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

29.17 Application of the Recognition and Measurement Rules

Future Operating Losses

Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future operating losses.

Restructuring

The following are examples of events that may fall under the definition of restructuring:

(a) Sale or termination of a line of business;

(b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) Changes in management structure, for example, eliminating a layer of management; and

(d) Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the recognition criteria for provisions. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

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

(a) Necessarily entailed by the restructuring; and

(b) Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

(a) Retraining or relocating continuing staff;

(b) Marketing; or

(c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

29.18 Disclosure

For each class of provision, an enterprise should disclose:

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

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

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

(d) Unused amounts reversed during the period.

SMCs are exempt from the disclosure requirements of AS 29

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

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

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

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

SMCs are exmpt from the disclosure requirements of AS 29

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

(a) An estimate of its financial effect,

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

(c) The possibility of any reimbursement.

29.19 Miscellaneous Illustrations

Illustration 1

At the end of the financial year ending on 31st December, 2011, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	*Loss (₹)*
In respect of five cases (Win)	*100%*	*–*
Next ten cases (Win)	*60%*	*–*
Lose (Low damages)	*30%*	*1,20,000*
Lose (High damages)	*10%*	*2,00,000*
Remaining five cases		
Win	*50%*	*–*

Lose (Low damages)	*30%*	*1,00,000*
Lose (High damages)	*20%*	*2,10,000*

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

Solution

According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

(i) There is a present obligation arising out of past events but not recognized as provision.

(ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(iii) The possibility of an outflow of resources embodying economic benefits is also remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of ₹ 1,20,000 + 10% of ₹ 2,00,000

= ₹ 36,000 + ₹ 20,000

= ₹ 56,000

Expected loss in remaining five cases = 30% of ₹ 1,00,000 + 20% of ₹ 2,10,000

= ₹ 30,000 + ₹ 42,000

= ₹ 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 9,20,000 (₹ 56,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Reference: The students are advised to refer the full text of AS 29 "Provisions, Contingent Liabilities and Contingent Assets" (issued 2003).

UNIT 30 : AS 30 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

30.1 Introduction

Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and is recommendatory in nature for all commercial, industrial and business entities except to a Small and Medium-sized Entity (SME), as defined below:

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) Is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;

(iii) Its turnover (excluding other income) does not exceed rupees 50 crore in the immediately preceding accounting year;

(iv) It does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) Is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

From the date of this Standard becoming mandatory for the concerned entities, the following will stand withdrawn:

(i) Accounting Standard (AS) 4, *Contingencies and Events Occurring After the Balance Sheet Date*, to the extent it deals with contingencies.

(ii) Accounting Standard (AS) 11 (revised 2003), *The Effects of Changes in Foreign Exchange Rates*, to the extent it deals with the 'forward exchange contracts'.

(iii) Accounting Standard (AS) 13, *Accounting for Investments*, except to the extent it relates to accounting for investment properties.

From the date this Accounting Standard becomes recommendatory in nature, the following Guidance Notes issued by the Institute of Chartered Accountants of India, stand withdrawn:

(i) Guidance Note on Guarantees & Counter Guarantees Given by the Companies.

(ii) Guidance Note on Accounting for Investments in the Financial Statements of Mutual Funds.

(iii) Guidance Note on Accounting for Securitisation.

(iv) Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options.

30.2 Objective

The objective of this Standard is to establish the principles for recognising and measuring

a) financial assets,

b) financial liabilities and

c) some contracts to buy or sell non-financial items.

30.3 Scope

This Standard should be applied by all entities to all types of financial instruments except:

(a) those interests in subsidiaries, associates and joint ventures that are accounted for under AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint ventures

However, entities should apply this Standard to an interest in a subsidiary, associate or joint venture that according to AS 21, AS 23 or AS 27 is accounted for under this Standard. Entities should also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in AS 31, Financial Instruments: Presentation

(b) rights and obligations under leases to which AS 19, Leases, applies. However:

   (i) lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard

   (ii) finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard and

   (iii) derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard .

(c) employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies.

(d) financial instruments issued by the entity that meet the definition of an equity instrument in AS 31, Financial Instruments: Presentation (including options and warrants). However, the holder of such equity instruments should apply this Standard to those instruments, unless they meet the exception in (a) above.

(e) The issues are:-

   (i) rights and obligations arising under an insurance contract as defined in the Accounting Standard on Insurance Contracts* other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in paragraph or

* A separate Accounting on Insurance Contracts, which is being formulated, will specify the requirements relating to insurance contracts.

(ii) a contract that is within the scope of Accounting Standard on Insurance Contracts because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of Accounting Standard on Insurance Contract if the derivative is not itself a contract within the scope of that Standard. Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may choose to apply either this Standard or Accounting Standard on Insurance Contracts to such financial guarantee contracts. The issuer may make that choice contract by contract, but the choice made for each contract is irrevocable.

(f) contracts for contingent consideration in a business combination. This exemption applies only to the acquirer.

(g) contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date.

30.4 Definitions

A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

Underlying

An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement amount of a derivative.

Examples of underlyings include:

- A security price or security price index;
- A commodity price or commodity price index;
- An interest rate or interest rate index;
- A credit rating or credit index;
- A foreign exchange rate or foreign exchange rate index;
- An insurance index or catastrophe loss index;

- A climatic or geological condition (eg temperature, earthquake severity, or rainfall), another physical variable, or a related index; or
- Another variable (eg volume of sales).

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Definitions relating to Recognition and Measurement

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility. The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

De-recognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Definitions Relating to Hedge Accounting

A hedging instrument is

(a) a designated derivative or

(b) for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item

A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that (a) exposes the entity to risk of changes in fair value or future cash flows and (b) is designated as being hedged. Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

A firm commitment is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.

A forecast transaction is an uncommitted but anticipated future transaction.

Functional currency is the currency of the primary economic environment in which the entity operates.

30.5 Categories of Financial Instruments

The four categories are:

a) Financial Assets at fair value through profit or loss

b) Held to maturity

c) Loans & Recievable

c) Available for sale

Financial assets at Fair Value Through Profit or Loss (FVTPL)

FVTPL has two sub-categories. The first includes any financial asset that is designated on initial recognition as one to be measured at fair value with fair value changes in the statement of profit and loss (except for investments in equity instruments and derivatives linked to and must be settled by delivery of equity instruments where the equity instrument does not have a quoted market price in an active market for which fair value is reliably determinable.

This designation is irrevocable.

The second category includes fianacial assets which should be classified as held for trading. All derivative assets are held for trading financial assets measured at fair value through profit or loss, except for derivatives that are designated and effective hedging instruments. If a derivative asset is a hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation part of the fair value gains/losses will be recognized initially in equity. Fair value gains/losses for a derivative asset that is a hedging instrument in a fair value hedge will always be recognized in the statement of profit and loss, the same treatment as if the instruement was not in a hedge relationship at all.

Held for trading: A financial asset or financial liability is classified as held for trading if it is:

(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term; or

(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking;

(iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Examples of held for trading financial assets are:

- Equity securities bought and sold by defined benefit pension plan and investment companies that are actively traded by the entity;
- A portfolio of debt and/or equity securities managed by a trading desk;
- Reverse repurchase agreements that form part of a trading book; or
- Derivative financial instruments that are not effective hedging instruments.

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity other than:

(a) those that the entity upon initial recognition designates as at fair value through profit or loss;

(b) those that meet the definition of loans and receivables; and

(c) those that the entity designates as available for sale.

Held to-maturity investments are measured at amortised cost using the effective interest rate method.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than: (a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss; (b) those that the entity upon initial recognition designates as available for sale; or (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

Available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or are not classified as

(a) loans and receivables,

(b) held-to-maturity investments, or

(c) financial assets at fair value through profit or loss.

30.6 Embedded Derivatives

An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

An embedded derivative should be separated from the host contract and accounted for as a derivative under this Standard if, and only if:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the statement of profit and loss (i.e., a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

If an embedded derivative is separated, the host contract should be accounted for under this Standard if it is a financial instrument, and in accordance with other appropriate Standards if it is not a financial instrument.

This Standard does not address whether an embedded derivative should be presented separately on the face of the financial statements.

If a contract contains one or more embedded derivatives, an entity may designate the entire hybrid (combined) contract as a financial asset or financial liability at fair value through profit or loss unless:

(a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or

(b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

If an entity is required by this Standard to separate an embedded derivative from its host contract, but is unable to measure embedded derivative separately either at acquisition or at a subsequent financial reporting date, it should designate the entire hybrid (combined) contract as at fair value through profit or loss.

If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions (for example, because the embedded derivative is based on an unquoted equity instrument), the fair value of the embedded derivative is the difference between the fair value of the hybrid (combined) instrument and the fair value of the host contract, if those can be determined under this Standard.

Example: A lease contract contains a provision that rentals increase each year by 10%. Is there an embedded derivative in this contract?

Answer: No. There is no embedded derivative since lease rental does not depend on any underling basis.

Example: X Co. entered with Y Co. to sell coal over a period of two year. The coal price will be determined as per the increase in electricity prices. Is there an embedded derivative?

Answer: Yes, there is embedded derivative because cash flow of the contract or settlement price is dependent on underlying electricity price.

30.7 Recognition

Initial Recognition

An entity should recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument.When a financial asset or financial liability is recognised initially, an entity should measure it as follows:

(a) A financial asset or financial liability at fair value through profit or loss should be measured at fair value on the date of acquisition or issue.

(b) Short-term receivables and payables with no stated interest rate should be measured at original invoice amount if the effect of discounting is immaterial.

(c) Other financial assets or financial liabilities should be measured at fair value plus/ minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

De-recognition of a Financial Asset

Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

A. An entity should derecognise a financial asset when, and only when:

   (a) the contractual rights to the cash flows from the financial asset expire; or

   (b) it transfers the financial asset as set out in paragraphs B and C and the transfer qualifies for derecognition in accordance with paragraph D.

B. An entity transfers a financial asset if, and only if, it either:

   (a) transfers the contractual rights to receive the cash flows of the financial asset; or

   (b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions

C. When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.

   (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity to the eventual recipients with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in AS 3, Cash Flow Statements) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

D. When an entity transfers a financial asset (see paragraph B), it should evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

(a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity should derecognise the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.

(b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity should continue to recognise the financial asset.

(c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity should determine whether it has retained control of the financial asset. In this case:

(i) if the entity has not retained control, it should derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.

(ii) if the entity has retained control, it should continue to recognise the financial asset to the extent of its continuing involvement in the financial asset.

Regular Way Purchase or Sale of a Financial Asset

A regular way purchase or sale of financial assets should be recognised and derecognised using trade date accounting or settlement date accounting.

The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date.

The settlement date is the date on which an asset is delivered to or by an entity.

Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied, an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.

Hedging relationships are of three types:

AS 30 recognises three types of hedge accounting depending on the nature of the risk exposure:

(a) *fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss. Fair value exposures arise from existing assets or liabilities, including firm commitments. Fixed-rate financial assets and liabilities, for example, have a fair value exposure to changes in market rates of interest and changes in credit quality. Non-financial assets have a fair value exposure to changes in their market price, eg a commodity price. Some assets and liabilities have fair value exposures arising from more than one type of risk, eg interest rate, credit, foreign currency risk.

    The following assets and liabilities are commonly fair value hedged:

    - Fixed rate liabilities like loans;
    - Fixed rate assets like investments in bonds;
    - Investments in equity securities; and
    - Firm commitments to by/sell non-financial items at fixed price.

    Firm commitment

    A firm commitment is a binding agreement for the exchange of a specified quantity or resources at a specified price on a specified future date or dates.

    Hedges of firm commitments are generally treated as fair value hedges under AS 30. However, there is one exception: if an entity is hedging the foreign exchange risk in a firm commitment this may be accounted for either as a fair value hedge or a cash flow hedge.

(b) *cash flow hedge*: a hedge of the exposure to variability in cash flows that

    (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and

    (ii) could affect profit or loss.

    Common assets and liabilities and forecast transactions that are cash flow hedged include:

    - Variable rate liabilities like loans;
    - Variable rate assets like investments in bonds;
    - Highly probable future issuance of fixed rate debt;

- Forecast reinvestment of interest and principal received on fixed rate assets; and
- Highly probable forecast sales and purchases.

An example of a cash flow hedge is a hedge of variable rate debt with a floating to fixed interest rate swap. The cash flow hedge reduces future variability of interest cash flows on the debt. A hedging instrument that swaps one variable rate for another, eg LIBOR for MIBOR, would not qualify in a cash flow hedge relationship as it does not reduce cash flow variability, it merely swaps the existing cash flow variability of the debt for cash flow variability determined on a different basis.

Forecast transactions

A forcast transaction is an uncommitted but anticipated future transaction.

It is important to distinguish between forecast transactions and firm commitments as forecast transactions are always cash flow hedged, whereas firm commitments are generally fair value hedged.

(c) *hedge of a net investment* in a foreign operation as defined in AS 11. (Net investment Hedge)

A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

A hedging relationship qualifies for **hedge accounting** only if, **all** of the following conditions are met.

(a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item’s fair value or cash flows attributable to the hedged risk.

(b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

(c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be reliably measured, i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

(e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

Fair Value Hedges

A fair value hedge should be accounted for as follows:

(a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with AS 11 (for a non-derivative hedging instrument) should be recognised in the statement of profit and loss; and

(b) the gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognised in the statement of profit and loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in the statement of profit and loss applies even if the hedged item is an available-for-sale financial asset.

Cash Flow Hedges

A cash flow hedge should be accounted for as follows:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised directly in an appropriate equity account, say, Hedging Reserve Account; and

(b) the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss.

Hedges of a Net Investment

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment , should be accounted for similarly to cash flow hedges:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge[*] should be recognised directly in the appropriate equity account; and

(b) the portion of the gain or loss on the hedging instrument that is determined to be an ineffective hedge should be recognised in the statement of profit and loss.

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised directly in the equity account should be recognised in the statement of profit and loss on disposal of the foreign operation.

Hedge Accounting

As required by the Standard, <u>on the date of this Standard becoming mandatory</u>, an entity should:

(a) measure all derivatives at fair value; and

(b) eliminate all deferred losses and gains, if any, arising on derivatives that under the previous accounting policy of the entity were reported as assets or liabilities.

[*] For a hedge to be effective, para A129 of AS 30 requires that it should be within the range of 80 to125%.

Any resulting gain or loss (as adjusted by any related tax expense/ benefit) should be adjusted against opening balance of revenue reserves and surplus.

On the date of this Standard becoming mandatory, an entity should not reflect in its financial statements a hedging relationship of a type that does not qualify for hedge accounting under this Standard (for example, hedging relationships where the hedging instrument is a cash instrument or written option; where the hedged item is a net position; or where the hedge covers interest risk in a held-to-maturity investment).

However, if an entity designated a net position as a hedged item under its previous accounting policy, it may designate an individual item within that net position as a hedged item under Accounting Standards, provided that it does so on the date of this Standard becoming mandatory.

If, before the date of this Standard becoming mandatory, an entity had designated a transaction as a hedge but the hedge does not meet the conditions for hedge accounting in this Standard, the entity should discontinue hedge accounting. Transactions entered into before the date of this Standard becoming mandatory should not be retrospectively designated as hedges.

Example: Omega Ltd. has entered into hedging relationship. At the year end the entity assesses the fair value of the hedged item and hedging instrument and the gains and losses arise as follows:

Hedged Item – gain of ₹ 1,000

Hedged instrument – loss of ₹ 1,200

The effectiveness of the hedge has been calculated as:

₹ 1,200/1,000 = 120%. The hedge is assessed as highly effective as it is between 80 to 125%.

Embedded Derivatives

An entity that applies this Standard for the first time should assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed on the date it first became a party to the contract or on the date on which a reassessment is required by whichever is the later date.

30.8 Miscellaneous Illustrations

Illustration 1

On February 1, 2011 Omega Ltd enters in to a contract with Beta Ltd. to receive the fair value of 1000 Omega's own equity shares outstanding as of 31.1.2012 in exchange for payment of ₹1,04,000 in cash i.e., ₹104 per share on 31.1.2012. The contract will be settled in net cash-

(i) fair value of forward on 1.2.2011 - Nil

(ii) fair value of forward 31.12.2011 ₹6,300

(iii) fair value of forward 31.1.2012 ₹2,000.

Give journal entries on the basis that the net amount is settled in cash. Omega Ltd closes its books on 31st December.

Solution

(a)	1.2.2011			
	No entry is required because the fair value of derivatives is zero and no cash is paid or received			
(b)	31.12.2011			
	Forward Asset	Dr.	6,300	
	To Gain			6,300
(c)	31.1.2012			
	Loss	Dr.	4,300	
	To Forward Asset			4,300
(d)	Cash	Dr.	2,000	
	To Forward asset			2,000

Illustration 2

X Ltd. is a subsidiary of Y Ltd. It holds 9% ₹ 100 5-year debentures of Y Ltd. and designated them as held to maturity as per AS 30 "Financial Instruments: Recognition and Measurement". Can X Ltd. designate this financial asset as hedging instrument for managing foreign currency risk?

Solution

Para 82 of AS 30 states that for hedge accounting purposes only instruments that involve a party external to the reporting entity can be designated as hedging instrument. Therefore, debenture issued by the parent company cannot be designated as hedging instrument for the purpose of consolidated financial statements of the group. However, it can be designated as hedging instrument for separate financial statements of X Ltd.

Reference: The students are advised to refer the full text of AS 30.

UNIT 31 : AS 31 FINANCIAL INSTRUMENTS: PRESENTATION

31.1 Introduction

Accounting Standard (AS) 31, Financial Instruments: Presentation, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for all commercial, industrial and business entities except to a Small and Medium-sized Entity, as defined below:

(i) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank (including co-operative bank), financial institution or any entity carrying on insurance business;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose, an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period. Where, in respect of an entity there is a statutory requirement for presenting any financial instrument in a particular manner as liability or equity and/ or for presenting interest, dividend, losses and gains relating to a financial instrument in a particular manner as income/ expense or as distribution of profits, the entity should present that instrument and/ or interest, dividend,losses and gains relating to the instrument in accordance with the requirements of the statute governing the entity.

31.2 Objective

The objective of this Standard is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the prespective of issuer, into financial assets, liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement* and for disclosing information about them in Accounting Standard (AS) 32, *Financial Instruments: Disclosures*

This Standard should be applied by all entities to all types of financial instruments except:

a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investments in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates, or AS 27, Financial Reporting of Interests in Joint Ventures. However, in some cases, AS 21, AS 23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Standard. Entities should also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.

b) employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies.

c) contracts for contingent consideration in a business combination.

d) insurance contracts as defined in the Accounting Standard on Insurance Contracts. However, this Standard applies to derivatives that are embedded in insurance contracts if Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement requires the entity to account for them separately.

e) financial instruments that are within the scope of the Accounting Standard on Insurance Contracts because they contain a discretionary participation feature.

f) financial instruments, contracts and obligations under share-based payment transactions except for treasury shares, purchased, sold, issued or cancelled in connection with employee share option plans, employees share purchase plans, and all other share-based payment arrangements.

This Standard should be applied to those contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non financial item in accordance with the entity's expected purchase, sale or usage requirements.

31.3 Definitions

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

A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A **financial asset** is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

   (i) to receive cash or another financial asset from another entity; or

   (ii) to exchange financial assets or financial liabilities with another entity under

conditions that are potentially favourable to the entity; or (d) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.
A **financial liability** is any liability that is: (a) a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or (b) a contract that will or may be settled in the entity's own equity instruments and is (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity 's own equity instruments.
An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

31.4 Financial Assets and Financial Liabilities

Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are: (a) trade accounts receivable and payable;(b) bills receivable and payable; (c) loans receivable and payable; (d) bonds receivable and payable; and (e) deposits and advances.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

Gold bullion is not a financial instrument, it is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in the bullion.

The definition of a financial asset also includes certain derivative and non-derivative contracts indexed to, or settled in, an issuer's equity instruments.

31.5 Equity Instruments

Examples of equity instruments include

a. non-puttable equity shares,

b. some types of preference shares and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable equity shares in the issuing entity in exchange for a fixed amount of cash or another financial asset.

An obligation of an entity to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity. However, if such a contract contains an obligation for the entity to pay cash or another financial asset, it also gives rise to a liability for the present value of the redemption amount. An issuer of non-puttable equity shares assumes a liability when it formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following the declaration of a dividend or when the entity is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

In classifying a financial instrument as liability or equity classification is appropriate only if the instrument fails the definition of a financial liability

The key requirement in determining whether an instrument is equity is the issuer's unconditional ability to avoid delivery of cash or another financial asset. That ability is not affected by:

- the history of making distributions;
- an intention to make distributions in the future;
- a possible negative impact on the price of ordinary shares of the issuer if the distributions are not made on the instrument concerned;
- the amount of the issuer's reserves;
- an issuer's expectations of a profit or loss for the period; or
- an ability or inability or the issuer to influence the amount of its profit or loss for the period.

31.6 Derivative Financial Instruments

Financial instruments include primary instruments (such as receivables, payables and equity instruments) and derivative financial instruments (such as financial options, futures and forwards, interest rate swaps and currency swaps). Derivative financial instruments meet the definition of a financial instrument and accordingly, are within the scope of this Standard. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable.

31.7 Presentation

Liabilities and Equity

A financial instrument or its component parts should be classified by the issuer upon initial recognition as a financial liability or an equity instrument according to the substance of the contractual arrangement, not its legal form, and the definitions of a financial liability and an equity instrument. Whilst some instruments may have the legal form of equity their substance is one of a liability. A preference share, for instance, may display either equity or liability characteristics depending on the substance of the rights that attach to it. The approptiate classification is determined by the entity at the point of initial recognition and is not changed subsequently. When classifying a financial instrument in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and holders of the instrument. A financial instrument issued by a subsidiary could be classified as equity in the individual financial statements and as a liability in the consolidated financial statements if another group entity has provided a guarantee to make payments to the holder of the instrument.

a) The issuer of a financial instrument should classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.

b) No Contractual Obligation to Deliver Cash or another Financial Asset

Settlement Options

When a derivative financial instrument gives one party a choice over how it is settled (eg the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

In consolidated financial statements, an entity presents minority interests - i.e. the interests of other parties in the equity and income of its subsidiaries in accordance with AS 1 (revised)13, Presentation of Financial Statements, and AS 21, Consolidated Financial Statements and Accounting for Investments in subsidiaries in Separate Financial Statements.

When classifying a financial instrument (or a component of it) in consolidated financial statements, an entity considers all terms and conditions agreed between members of the group and the holders of the instrument in determining whether the group as a whole has an obligation to deliver cash or another financial asset in respect of the instrument or to settle it in a manner that results in liability classification.

When a subsidiary in a group issues a financial instrument and a parent or other group entity agrees additional terms directly with the holders of the instrument (e.g. a guarantee), the group may not have discretion over distributions or redemption. Although the subsidiary may appropriately classify the instrument without regard to these additional terms in its individual financial statements, the effect of other agreements between members of the group and the holders of the instrument is considered in order to ensure that consolidated financial statements reflect the contracts and transactions entered into by the group as a whole. To the extent that there is such an obligation or settlement provision, the instrument (or the component of it that is subject to the obligation) is classified as a financial liability in consolidated financial statements.

Treasury shares

If an entity reacquires its own equity instruments, those instruments ('treasury shares') should be deducted from equity. No gain or loss should be recognised in statement of profit and loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.

The acquisition and subsequent resale by an entity of its own equity instruments represents a transfer between equity holders (specifically between those who have given up their equity interest and those who continue to hold an equity instrument) rather than a gain or loss to the entity. Accordingly, any consideration paid or received is recognized in equity.

Such treasury shares may be acquired and held by the entity or by other members of the consolidated group.

The amount of treasury shares held is disclosed separately either on the face of the balance sheet or in the notes in accordance with AS 1 (revised) Presentation of Financial Statements (under formulation). An entity provides disclosure in accordance with the requirements of AS 18 Related Party Disclosures in instances where the entity reacquires its own equity instruments from related parties.

Interest, Dividends, Losses and Gains

Interest, dividends, losses and gains relating to a financial instrument or a component of financial instrument that is a financial liability should be recognised as income or expense in the statement of profit and loss. Distributions to holders of an equity instrument should be debited by the entity directly to an appropriate equity account, net of any related income tax benefit. Transaction costs of an equity transaction should be accounted for as a deduction from equity net of any related income tax benefit.

Offsetting a Financial Asset and a Financial Liability

A financial asset and a financial liability should be offset and the net amount presented in the balance sheet when, and only when, an entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity should not offset the transferred asset and the associated liability

When offset is applied, the entity will have the right to pay or receive a single net amount in relation to the two instruments, and intends to do so and, therefore, in effect the entity only has a single financial asset or financial liability. If the conditions of offset are not met then the two financial instruments are presented separately. Whether or not a financial asset and a financial liability is offset, they shall be measured in accordance with the normal measurement guidance with respect to financial assets and financial liabilities.

Illustration

X Ltd. has entered into a contract by which it has the option to sell its identified Property, Plant and Equipment (PPE) to Y Ltd. for ₹ 100 million after 3 years whereas its current market price is ₹ 180 million. Is the put option of X Ltd. a financial instrument? Explain.

Answer

It is necessary to evaluate the past practice of X Ltd. If X Ltd. has the past practice of settling net, then it becomes a financial instrument. If X Ltd. Intends to sell the identified PPE and settle by delivery and there is no past practice of settling net, then the contract should not be accounted for as derivative under AS 30 and AS 31.

Reference: The Students are advised to refer the full text of AS 31.

UNIT 32 : AS 32 FINANCIAL INSTRUMENTS: DISCLOSURES

32.1 Introduction

Accounting Standard (AS) 32, Financial Instruments: Disclosures, issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for all commercial, industrial and business entities except to a Small and Medium-sized Entity,as defined below:

a) Whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

b) which is not a bank (including a co-operative bank), financial institution or any entity carrying on insurance business;

c) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

d) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year

e) which is not a holding or subsidiary entity of an entity which is not a small and medium-sized entity.

For the above purpose an entity would qualify as a Small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

32.2 Objective and Scope of the Standard

The objective of this Standard is to require entities to provide disclosures in their financial statements that enable users to evaluate:

a) the significance of financial instruments for the entity's financial position and performance; and

b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The principles in this Accounting Standard complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement and Accounting Standard (AS) 31, Financial Instruments: presentation.

AS 32 should be applied by all entities to all types of financial instruments, except:

a) those interests in subsidiaries, associates and joint ventures that are accounted for in accordance with AS 21, Consolidated Financial Statements and Accounting for Investment in Subsidiaries in Separate Financial Statements, AS 23, Accounting for Investments in Associates3, or AS 27, Financial Reporting of Interests in Joint Ventures.

However, in some cases, AS 21, AS 23 or AS 27 permits or requires an entity to account for an interest in a subsidiary, associate or joint venture using Accounting Standard (AS) 30, Financial Instruments: Recognition and Measurement; in those cases, entities should apply the disclosure requirements in AS 21, AS 23 or AS 27 in addition to those in this Accounting Standard. Entities should also apply this Accounting Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in AS 31.

b) employers' rights and obligations arising from employee benefit plans, to which AS 15, Employee Benefits, applies.

c) contracts for contingent consideration in a business combination. This exemption applies only to the acquirer.

d) insurance contracts as defined in Accounting Standard on Insurance contracts.

e) financial instruments, contracts and obligations under share-based payment Transactions.

This Accounting Standard applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of AS 30. Unrecognised financial instruments include some financial instruments that, although outside the scope of AS 30, are within the scope of this Accounting Standard (such as some loan commitments).

32.3 Disclosure for Different Classes of Financial Instruments

When this Accounting Standard requires disclosures by class of financial instrument, an entity should group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. An entity should provide sufficient information to permit reconciliation to the line items presented in the balance sheet.

The classes should be determined by the entity and are distinct from the categories of financial instruments, as specified by AS 30. At a minimum the classes are required to distinguish between those finaicial instruments that are measured at amortised cost from those that are measured at fair value and should treat as a separate class or classes those financial instruments that are outside the scope of AS 32 (where the entity wishes to provide additional disclosure over and above the requirements of AS 32). In many instances, classes of financial instruments will be more granular than the categories of financial instruments. For example, loans and receivables is a financial instrument category that could comprise various classes like home loans, credit card loans, unsecured medium term loans etc.

32.4 Significance of Financial Instruments for Financial Position and Performance

An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance. To achieve this, disclosures must be provided for the balance sheet, statement of profit and loss and equity.

Balance sheet

Categories of financial assets and financial liabilities

The carrying amounts of each of the following categories, as defined in AS 30, should be disclosed either on the face of the balance sheet or in the notes:

(a) financial assets at fair value through profit or loss, showing separately

  (i) those designated as such upon initial recognition and

  (ii) those classified as held for trading in accordance with AS 30;

(b) held-to-maturity investments;

(c) loans and receivables;

(d) available-for-sale financial assets;

(e) financial liabilities at fair value through profit or loss, showing separately

  (i) those designated as such upon initial recognition and

  (ii) those classified as held for trading in accordance with AS 30; and

(f) financial liabilities measured at amortised cost.

Financial assets or financial liabilities at fair value through profit or loss

If the entity has designated a loan or receivable (or group of loans or receivables) as at fair value through profit or loss, it should disclose:

a) the maximum exposure to credit risk at the reporting date.

b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.

c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:

  (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

  (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.

d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.

If the entity has designated a financial liability as at fair value through profit or loss in accordance with AS 30, it should disclose:

a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

   (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or

   (ii) using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability. Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature, changes in market conditions include changes in the performance of the related internal or external investment fund.

b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

32.5 Disclosures

The entity should disclose:

(a) the methods used to comply

(b) if the entity believes that the disclosure it has given to comply and it does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

32.6 Reclassification

If the entity has reclassified a financial asset as one measured:

(a) at cost or amortised cost, rather than at fair value; or

(b) at fair value, rather than at cost or amortised cost,

It should disclose the amount reclassified into and out of each category and the reason for that reclassification.

Some classification decisions depend on management's intent as regards the purpose for which the instruments are used. Reclassifications from cost/ amortised cost to fair value and vice versa may occur in limited circumstances and it is important to understand the reasons for such reclassifications since understanding or the reasons may assist the users in judging how management's intent squares with its actions. Such information is also useful to the user in understanding the performance of the entity since reclassifications of such instruments can have a significant effect on their measurement.

32.7 Derecognition

An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition. The entity should disclose for each class of such financial assets:

a) the nature of the assets;

b) the nature of the risks and rewards of ownership to which the entity remains exposed;

c) when the entity continues to recognise all of the assets, the carrying amounts of the assets and of the associated liabilities; and

d) when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets, the amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

For example, a sale of a portfolio of receivables with a limited guarantee may result in the entity continuing to recognize the receivables and be exposed to the receivables but to a lesser extent than prior to the transfer.

The disclosures for derecognition are required by class of financial assets and can be provided either by type of financial assets (ie differentiating by characteristics of the assets) or by type of risks or rewards of ownership to which the entity remains exposed.

32.8 Collateral

An entity should disclose:

a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraphs 37(a) of AS 30; and

b) the terms and conditions relating to its pledge.

When an entity holds collateral (of financial or non-financial assets) and is permitted to sell or repledge the collateral in the absence of default by the owner of the collateral, it should disclose:

a) the fair value of the collateral held;

b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and

c) the terms and conditions associated with its use of the collateral.

The disclosure of the existence of such collateral is important since it provides information to the user of the financial statements of the amount of collateral used and available for use that may not be recognized on the balance sheet of the entity.

Disclosure of collateral that the entity does not have the right to sell or pledge in the absence of default by the borrower is required in the credit risk disclosures note

32.9 Allowance Account for Credit Losses

When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it should disclose a reconciliation of changes in that account during the period for each class of financial assets.

32.10 Compound Financial Instruments with Multiple Embedded Derivatives

If an entity has issued an instrument that contains both a liability and an equity Component and the instrument has multiple embedded derivatives whose values are interdependent (such as a callable convertible debt instrument), it should disclose the existence of those features.

32.11 Defaults and Breaches

For loans payable recognised at the reporting date, an entity should disclose:

a) details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;

b) the carrying amount of the loans payable in default at the reporting date; and

c) whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

If, during the period, there were breaches of loan agreement terms, an entity should disclose the same information if those breaches permitted the lender to demand accelerated repayment (unless the breaches were remedied, or the terms of the loan were renegotiated, on or before the reporting date).

Such disclosures are designed to provide the users with the relevant information about the entity's creditworthiness and its prospects of obtaining future loans.

The presentation of such loans as either current or non-current in accordance with the requirements of AS 1 (revised) Presentation of Financial Statements may also be affected by such defaults.

32.12 Statement of Profit and Loss and Equity

Items of income, expense, gains or losses

An entity should disclose the following items of income, expense, gains or losses either on the face of the financial statements or in the notes:

(a) net gains or net losses on:

   (i) financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with AS 30;

(ii) available-for-sale financial assets, showing separately the amount of gain or loss recognised directly in equity during the period and the amount removed from equity and recognised in the statement of profit and loss for the period;

(iii) held-to-maturity investments;

(iv) loans and receivables; and

(v) financial liabilities measured at amortised cost.

(b) total interest income and total interest expense (calculated using the effective interest method) for financial assets or financial liabilities that are not at fair value through profit or loss;

32.13 Nature and Extent of Risks Arising from Financial Instruments

An entity should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date.

32.14 Qualitative Disclosures and Quantitative Disclosures

For each type of risk arising from financial instruments, an entity should disclose:

(a) the exposures to risk and how they arise;

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk; and

(c) any changes in (a) or (b) from the previous period.

For each type of risk arising from financial instruments, an entity should disclose:

(a) summary quantitative data about its exposure to that risk at the reporting date. This disclosure should be based on the information provided internally to key management personnel of the entity (as defined in AS 18 Related Party Disclosures), for example the entity's board of directors or chief executive officer.

(b) the disclosures to the extent not provided in (a), unless the risk is not material for a discussion of materiality.

(c) Concentrations of risk if not apparent from (a) and (b)

If the quantitative data disclosed as at the reporting date are unrepresentative of an entity's exposure to risk during the period, an entity should provide further information that is representative.

32.15 Credit Risk

Credit risk is defined as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

An entity should disclose by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the reporting date without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with AS 31);

(b) in respect of the amount disclosed in (a), a description of collateral held as security and other credit enhancement;

(c) information about the credit quality of financial assets that are neither past due nor impaired; and

(d) the carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

32.16 Liquidity Risk

Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. Liquidity risk arises because of the possibility (which may often be remote) that the entity could be required to pay its liabilities earlier than expected.

An entity should disclose:

(a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and

(b) a description of how it manages the liquidity risk inherent in (a).

32.17 Sensitivity Analysis

The entity should disclose:

(a) a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;

(b) the methods and assumptions used in preparing the sensitivity analysis; and

(c) changes from the previous period in the methods and assumptions used, and the reasons for such changes.

If an entity prepares a sensitivity analysis, such as value-at-risk, that reflects interdependencies between risk variables (eg interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis.

The entity should also disclose:

(a) an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided; and

(b) an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

32.18 Other Market Risk Disclosures

When the sensitivity analyses disclosed in above or they are unrepresentative of a risk inherent in a financial instrument (for example because the year-end exposure does not reflect the exposure during the year), the entity should disclose that fact and the reason it believes the sensitivity analyses are unrepresentative.

Reference: The students are advised to refer the full text of AS 32.

UNIT 33 : GUIDANCE NOTES

33.1 Introduction

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. In recent years several Guidance Notes on accounting aspects have been issued promptly responding to the need for accounting guidance on contemporary issues, which arise due to amendments in laws and other developments related to economic reforms in the country. These Guidance Notes are issued by the Council of the ICAI from time to time.

Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

33.2 Status of Guidance Notes

In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

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

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

33.3 Guidance Notes on Accounting Aspects

The following is the list of applicable guidance notes on accounting aspects:

1. GN(A) 3 (Issued 1982) Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets
2. GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements

3. GN(A) 6 (Issued 1988)Guidance Note on Accrual Basis of Accounting
4. GN(A) 7 (Issued 1989) Guidance Note on Accounting for Depreciation in Companies
5. GN(A) 9 (Issued 1994) Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares
6. GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax
7. GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty
8. Guidance Note on Accounting Treatment for MODVAT/ CENVAT(under revision)
9. GN(A) 18 (Issued 2005)Guidance Note on Accounting for Employee Share-base Payments
10. GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961
11. GN(A) 24 (Issued 2006) Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25
12. Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings per Share.
13. Guidance Note on Remuneration paid to key management personnel – whether a related party transaction.
14. Guidance Note on Applicability of AS 25 to Interim Financial Results.
15. Guidance Note on Turnover in case of Contractors.
16. *Guidance Note on the Revised Schedule VI (Now Schedule III to the companies Act, 2013) to the Companies Act, 1956*

33.4 An Overview of Guidance Notes

GN(A) 3 (Issued 1982) Guidance Note on Treatment of Reserve Created on Revaluation* of Fixed Assets

The Guidance Note provides detailed consideration of various aspects regarding treatment of reserve created on revaluation of fixed assets. Companies normally revalue fixed assets in order to bring into books the replacement cost of such assets. The Guidance Note states that it will be prudent not to charge the additional depreciation against revaluation reserve, though this may result in reduction of distributable profits and will not give a realistic appraisal of the company's operations in inflationary conditions.

GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements

The objective of this guidance note is to facilitate a broad and basic understanding of the various terms as well as to promote consistency and uniformity in their usage. The terms have been defined in this guidance note, keeping in view their usage in the preparation and presentation of the financial statements. Some of these terms may have different meanings

* For accounting treatment of revaluation reserves in amalgamations, the students are advised to refer AS 14 "Accounting for Amalgamations".

when used in the context of certain special enactments. The definitions of the terms in this guidance note do not spell out the accounting procedure and are not prescriptive of a course of action.

GN(A) 6 (Issued 1988) Guidance Note on Accrual Basis of Accounting

This guidance note is issued by the Research Committee of the ICAI providing guidance in respect of maintenance of accounts on the accrual basis of accounting.The Guidance Note explains the concept of accrual as a basis of accounting, particularly, in comparison with the cash basis of accounting. It also deals generally with the matters of recognition of revenue and expenses, assets and liabilities. A section of the Guidance Note is devoted to the concept of materiality vis-a-vis accrual basis of accounting. It also provides guidance to the auditor in case a company has not maintained its accounts on accrual basis. Illustrations highlighting application of the principles explained in the Guidance Note to certain important commercial situations have also been given in the Guidance Note.

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. “Accrual” is one of the fundamental accounting assumptions. Para 27 of the Accounting Standard on Disclosure of Accounting Policies (AS-1), issued by the Institute of Chartered Accountants of India (ICAI), provides that if fundamental accounting assumptions, viz., going concern, consistency and accrual are not followed, the fact should be disclosed.

GN(A) 7 (Issued 1989) Guidance Note on Accounting for Depreciation in Companies

The subject of accounting for depreciation has always been a matter of crucial importance for the purpose of true and fair determination of the operating results of an entity and the depiction of its financial position through its profit and loss account and the balance sheet, respectively. With a view to provide an authoritative position of the Institute on the issues arising out of the said amendments in this regard and to consolidate and revise the existing pronouncements on the subject of accounting for depreciation, in particular reference to the companies, issued by the Institute and its various Committees, the Research Committee of the Institute has brought out this Guidance Note on Accounting for Depreciation in Companies. This Guidance Note on Accounting for Depreciation in Companies, accordingly, comprehensively deals with various aspects of accounting for depreciation, such as, methods of charging depreciation (including change in the method of providing depreciation), relevant rates of depreciation for the purpose of preparation of accounts of a company with particular reference to Schedule XIV, pro-rata computation of depreciation, depreciation on low value items, charge of depreciation in case of revaluation of assets and other matters arising on account of amendments in the Companies Act, 1956

GN(A) 9 (Issued 1994) Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares

This Guidance Note discusses the nature of revaluation reserve and in this context examines the question whether such reserves can be utilised for issue of bonus shares. Revaluation of fixed assets is one of the issues dealt with in Accounting Standard (AS) 10 on ‘Accounting for Fixed Assets’, issued by the Institute of Chartered Accountants of India. According to this

Guidance Note, bonus shares cannot be issued by capitalisation of revaluation reserve. If any company (including a private or a closely held public company) utilises revaluation reserve for issue of bonus shares, the statutory auditor of the company should qualify his audit report.

GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax

Corporate Dividend Tax (CDT) is in addition to the income-tax chargeable in respect of the total income of a domestic company and was introduced under The Finance Act, 1997. The Guidance Note on Accounting for Corporate Dividend Tax explains the salient features of Corporate Dividend tax (CDT). As per the Guidance Note, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year. The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed ‘below the line’, it is appropriate that the liability in respect of CDT should also be disclosed ‘below the line’ as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty

Excise duty is a duty on manufacture or production of excisable goods in India. Section 3 of the Central Excise Act, 1944, deals with charge of Excise Duty. This Section provides that a duty of excise on excisable goods which are produced or manufactured in India shall be levied and collected in such manner as may be prescribed. The subject of accounting of excise duty has, so far, beset with certain controversies, yet, the ICAI with the issuance of this Guidance Note, has recommended practices which are broadly in accordance with the generally accepted accounting principles would be well established. Subsequent to the issuance of that Guidance Note, the nature of excise duty has been further clarified by some Supreme Court decisions. Further, the principles to be followed for the valuation of inventories have been explained in the Accounting Standard (AS) 2 on ‘Valuation of Inventories’, issued by the Institute of Chartered Accountants of India. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now renamed as ‘CENVAT’). In considering the appropriate treatment of excise duty for the purpose of determination of cost for inventory valuation, it is necessary to consider whether excise duty should be considered differently from other expenses. As per the recommendations given in the Guidance Note, Excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation. Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods. Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made. Excise duty cannot be treated as a period cost and if the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.

Guidance Note on Accounting Treatment for MODVAT/CENVAT

The objective of this Guidance Note is to provide guidance in respect of accounting for MODVAT/CENVAT credit. Salient features of MODVAT and CENVAT are also explained in the guidance note. For accounting treatment of excise duty with regard to valuation of inventories, reference may be made to the Guidance Note on Accounting Treatment for Excise Duty, issued by the Institute of Chartered Accountants of India.

GN(A) 18 (Issued 2005) Guidance Note on Accounting for Employee Share-based Payments

Recognising the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. Once the Accounting Standard dealing with Share-based Payments comes into force, this Guidance Note will automatically stand withdrawn.

This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- Equity-settled: Under these plans, the employees receive shares.
- Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

An employee share-based payment plan falling in the above categories can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended here in below is based on the fair value method.

An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in this Guidance Note. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognise services received in full with a corresponding credit to the equity account. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 9 to 11). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognised for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, the enterprise should recognise an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, mutatis mutandis, in place of the fair value as described in paragraphs 5 to 14.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements. The appendices to the Guidance Note provide detailed guidance on measurement of fair value of shares and stock options, including determination of various inputs to the option-pricing models and examples to illustrate application of various principles recommended in the Guidance Note.

GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961

The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07. This Guidance Note deals with various aspects of accounting and presentation of MAT paid and the credit available in this regard. The Guidance Note describes the salient features of MAT credit and its accounting treatment. MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. MAT credit is a deferred tax asset for the purposes of AS 22 A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax during the specified period. Where a company recognises MAT credit as an asset on the basis of the considerations specified in the guidance note, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph the guidance note. According to paragraph 6 of Accounting Standards Interpretation (ASI)6, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

GN(A) 24 (Issued 2006) Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports. Accounting for interim period income-tax expense is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25 that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

Guidance Note on Applicability of Accounting Standard (AS) 20, Earnings Per Share

This Guidance Note deals with the issue whether companies which are required to give information under Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with Accounting Standard (AS) 20, Earnings Per Share.

Since Schedule VI to the Companies Act, 1956, requires, among other things, disclosure of earnings per share, every company which provides information under Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Guidance Note on Remuneration paid to Key Management Personnel - Whether a Related Party Transaction

This Guidance Note deals with the issue whether remuneration paid to key management personnel is a related party transaction. Another related issue dealt by this Guidance Note is whether remuneration paid to non-executive directors on the Board of Directors is a related party transaction.

As per the definition of the expression 'related party transaction', the transaction should be between related parties to qualify as a related party transaction. Since key management personnel are related parties under AS 18, remuneration paid to key management personnel is a related party transaction requiring disclosures under AS 18. Further, in case non-executive directors on the Board of Directors are not related parties, remuneration paid to them is not considered a related party transaction.

Guidance Note on Applicability of AS 25 To Interim Financial Results

This Guidance Note deals with the issue whether Accounting Standard (AS) 25, Interim Financial Reporting, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator, for example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises.

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

Guidance Note on Turnover in Case of Contractors

This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, Construction Contracts (revised 2002), can be considered as 'turnover'.

The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as 'turnover'.

Guidance Note on Revised Schedule VI (Now Schedule III to the companies Act, 2013)• to the Companies Act, 1956

The objective of this Guidance Note is to provide guidance in the preparation and presentation of Financial Statements of companies in accordance with various aspects of the Revised Schedule VI. However, it does not provide guidance on disclosure requirements under Accounting Standards, other pronouncements of the Institute of Chartered Accountants of India (ICAI), other statutes, etc.

33.5 Miscellaneous Illustrations

Illustration 1

HSL Ltd. is manufacturing goods for local sale and exports. As on 31st March, 2012, it has the following finished stocks in the factory warehouse:

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

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

Excise duty is payable at the rate of 16%. The company's Managing Director says that excise duty is payable only on clearance of goods and hence is not a cost. Please advise HSL using guidance note, if any issued on this, including valuation of stock.

Solution

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

According to Central Excise Rules, 2002, excise duty should be collected at the time of removal of goods from factory premises or factory warehouse. The levy of excise duty is upon the manufacture or production, the collection part of it is shifted to the stage of removal.

Further, paragraph 23(i) of the Guidance Note makes it clear that excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.

Therefore, in the given case of HSL Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 16% on the selling price, that is, ₹ 100 lakhs for valuation of stock.

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

Illustration 2

A factory went into commercial production on 1st April, 2012. It uses as its raw materials product X on which excise duty of ₹ 30 per Kg. is paid and product Y on which excise duty of ₹ 20 per kg. is paid. On 31st March, 2012 it had stock of 20,000 kgs. of X and 15,000 kgs. of Y which it had purchased at an all

• Now Schedule III to the companies Act, 2013.

inclusive price of ₹ 150 per kg. for X and ₹ 120 per kg. for Y. The suppliers of X and Yare to receive payment on 15th May, 2012.

During April 2012, the factory manufactured 40,000 units of the end product for which the consumption of material X was 60,000 kgs. and material Y was 45,000 kgs. The excise duty on the end product is ₹ 60 per unit. 30,000 units of the end product were dispatched, 8,000 units were kept in warehouse and balance 2,000 kgs. were kept in finished goods godown.

During the month the factory purchased 50,000 kgs. of X at ₹ 145 per kg. (inclusive of excise duty of ₹ 30 per kg.) on credit of 60 days and 50,000 kgs. of Y at ₹ 110 per kg. (inclusive of excise duty of ₹ 20 per kg.) on credit of 45 days.

The cost of "converting" the raw materials into finished product amounts to ₹ 150 per unit of end product of which ₹ 100 is "cash cost" paid immediately and ₹ 50 represents non-cash charge for depreciation. There is no work in process.

Sales are effected at ₹ 750 per unit in respect of credit transactions and at ₹ 700 per unit in respect of cash transactions. 20% of despatches were in respect of cash transactions while the balance 80% were in respect of credit transactions (one month credit).

You are required to:

(a) (i) Calculate modvat credit available, modvat credit availed of and balance in modvat credit as on 30th April, 2012.

(ii) Show the necessary ledger accounts in respect of modvat.

(b) Value the inventory of:

(i) raw material

(ii) finished goods in warehouse

(iii) finished goods in finished goods godown on "first in first out" principle.

(c) Show the ledger accounts of customers, suppliers and bank, assuming that the necessary bank balance is available at the start of the month to meet "cash" expenses of that month.

(d) Calculate the working capital as on 30th April, 2012.

(e) State the impact of 'modvat' on working capital requirement of the factory as on 30th April 2012.

Solution

(a) (i) Excise duty paid on raw materials:

	Kgs.	*X* *@* ₹	*Amount* ₹	*Kgs.*	*Y* *@* ₹	*Amount* ₹	*Total Amount* ₹
Stock on 31st March, 2012	20,000	30	6,00,000	15,000	20	3,00,000	9,00,000
Purchases	50,000	30	15,00,000	50,000	20	10,00,000	25,00,000
			21,00,000			13,00,000	34,00,000

Modvat credit available:

₹ 21,00,000 + 13,00,000 = ₹ 34,00,000

Modvat credit available of:

Production = 40,000 units

Excise duty on the end product = ₹ 60 per unit

Modvat credit availed of = 40,000 × 60 = ₹ 24,00,000

Balance in Modvat credit 34,00,000 – 24,00,000 = ₹ 10,00,000

Note: Normally goods are removed from factory on payment of excise duty. However, in respect of certain goods, provision has been made to store the goods in warehouses without payment of duty (Rule 20 of Central Excise Rules, 2002). These provisions are also applicable to goods transferred to customs warehouse.

It is to be noted that as per para 33 of The Guidance Note on Accounting Treatment for Excise Duty, it is necessary that a provision for liability in respect of unpaid excise duty should be made in the accounts in respect of stocks lying in the factory or warehouse since the liability for excise duty arises when the manufacture of the goods is completed.

(ii) Modvat Credit Receivable Account

Dr. 2012				2012		*Cr.* *Cr.*
April 1	To Balance b/d			April	By Excise Duty A/c	24,00,000
	X	6,00,000				
	Y	3,00,000				
			9,00,000	April 31	By Balance c/d	10,00,000
April	To Suppliers A/c					
	X	15,00,000				
	Y	10,00,000				
			25,00,000			
			34,00,000			34,00,000

Purchases Account

Dr. 2012			2012		*Cr.*
April	To Suppliers A/c		April 31	By Balance c/d	1,02,50,000
	X: [50,000 × (145 – 30)]	57,50,000			
	Y: [50,000 × (110 – 20)]	45,00,000			
		1,02,50,000			1,02,50,000

(b) Valuation of Inventory

(i) Raw material:

	X (Kgs.)	Y (Kgs.)
Opening stock	20,000	15,000
Purchases	50,000	50,000
	70,000	65,000
Consumption	60,000	45,000
Closing stock	10,000	20,000
Inventory:		₹
X : 10,000 × (145 – 30)		11,50,000
Y : 20,000 × (110 – 20)		18,00,000
		29,50,000

(ii) Finished goods in warehouse

		₹
Raw material cost of 80,000 units of output		
X : 12,000* × (145 – 30)	13,80,000	
Y : 9,000* × (110 – 20)	8,10,000	21,90,000
Conversion cost		
Cash cost : 8,000 × ₹ 100	8,00,000	
Non-cash : 8,000 × ₹ 50	4,00,000	12,00,000
Excise duty		
8,000 × ₹ 60		4,80,000
		38,70,000

* For 40,000 units of output,

input of X = 60,000 Kgs.

input of Y = 45,000 Kgs.

Therefore, for 8,000 units of finished goods in warehouse:

Input of X = $\frac{60,000}{40,000} \times 8,000 = 12,000$ Kgs.

Input of Y = $\frac{45,000}{40,000} \times 8,000 = 9,000$ Kgs.

(iii) Finished goods in finished goods godown

	₹
Cost of 8,000 units of finished goods in warehouse	38,70,000
Cost of 2,000 units of finished goods in finished goods godown $= \frac{38,70,000}{8,000} \times 2,000$	9,67,500

(c) Customers Account

Dr.	₹		*Cr.* ₹
To Sales A/c $\left(\frac{80}{100} \times 30,000 \times 750\right)$	1,80,00,000	By Balance c/d	1,80,00,000
	1,80,00,000		1,80,00,000

Suppliers Account

	₹		₹
To Balance c/d	1,75,50,000	By Balance b/d	
		X : 20,000 × ₹ 150 = 30,00,000	
		Y : 15,000 × ₹ 120 = 18,00,000	
			48,00,000
		By Purchases A/c	1,02,50,000
		By Modvat Credit Receivable A/c	
		X : 50,000 × 30 = 15,00,000	
		Y : 50,000 × 20 = 10,00,000	
			25,00,000
	1,75,50,000		1,75,50,000

Bank Account

	₹		₹
To Balance b/d	40,00,000	By Cash Expenses (40,000 × 100)	40,00,000
To Sales (cash sales) A/c $\left(\frac{20}{100} \times 30,000 \times ₹\ 700\right)$	42,00,000	By Balance c/d	42,00,000
	82,00,000		82,00,000

(d) Working Capital as on 30th April, 2012

Current Assets:

Inventory

(i)	Raw materials		
	X	11,50,000	
	Y	18,00,000	29,50,000
(ii)	Finished goods in warehouse	38,70,000	
	in finished goods godown	9,67,500	48,37,500
Customers			1,80,00,000
Bank balance			42,00,000
Modvat credit receivable			10,00,000
			3,09,87,500
Less: Current Liabilities			
Sundry creditors			(1,75,50,000)
			1,34,37,500

(e) Impact of Modvat on Working Capital Requirement

Modvat has enabled

(i) dispatch on sale of 30,000 units of finished product,

(ii) removal of 10,000 units of finished product,

without payment of a single rupee in cash. Cash outlay so saved at ₹ 60 per unit is ₹ 24,00,000.

It has also ensured creation of a current asset worth ₹ 10,00,000 in Modvat Credit Receivable Account.

Thus MODVAT reduces the pressure on working capital.

Illustration 3

Vikas Ltd. purchased a plant for ₹ 50 lakhs from Yash Ltd. during 2012 - 2013 and installed immediately. The price includes excise duty of ₹ 5 lakhs. During 2012 - 2013, the company produced excisable goods on which the excise authority charged excise duty to the extent of ₹ 4.5 lakhs. Show the necessary Journal Entries explaining the treatment of CENVAT credit. You are also required to indicate the value of plant at which it should be recorded in Fixed Asset register.

Answer

(i) Journal Entries

			₹ in lakhs	
(a)	Plant and Machinery A/c	Dr.	45	
	Cenvat credit receivable on capital goods A/c	Dr.	5	

	To Bank A/c or Creditors A/c			50
	(Being capitalization of plant and machinery)			
(b)	Excise duty A/c	Dr.	2.5	
	To Cenvat credit receivable on capital goods A/c			2.5
	(Being excise duty set off available to the extent of 50% in the first year of acquisition of capital asset)			

(ii) Value of plant to be recorded in Fixed Asset Register: As per Guidance Note on "Accounting Treatment for CENVAT", fixed assets have to be capitalised net of refundable amounts.

The plant and machinery will be recorded at ₹ 45 lakhs (₹ 50 lakhs - ₹ 5 lakhs) in the fixed asset register.

Illustration 4

A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 2011 it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130. The options were to be exercised between 16th December, 2011 and 15th March, 2012. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

Journal Entries

	Particulars		*Dr.* ₹	*Cr.* ₹
2011				
April 1	Employee Compensation Expense	Dr.	9,00,000	
	To Employee Stock Options Outstanding			9,00,000
	(Being grant of 10,000 stock options to employees at ₹ 40 when market price is ₹ 130)			
2012				
16th Dec.	Bank	Dr.	3,80,000	
to 15th	Employee stock options outstanding	Dr.	8,55,000	
March	To Equity share capital			95,000
	To Securities premium			11,40,000
	(Being allotment to employees of 9,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share in exercise of stock options by employees)			
March 16	Employee stock options outstanding	Dr.	45,000	
	To Employee compensation expense			45,000
	(Being entry for lapse of stock options for 500 shares)			

March 31	Profit and Loss A/c To Employee compensation expense (Being transfer of employee compensation expense to profit and loss account)	Dr.	8,55,000	 8,55,000

Illustration 5

Mr. Investor buys a stock option of ABC Co. Ltd. in July, 2011 with a strike price ₹250 to be expired on 30th August, 2011. The premium is ₹20 per unit and the market lot is 100. The margin to be paid is ₹ 120 per unit.

Show the accounting treatment in the books of Buyer when:

(i) the option is settled by delivery of the asset, and

(ii) the option is settled in cash and the Index price is ₹ 260 per unit.

Solution

Accounting entries in the books of buyer

July, 2011	Equity stock option premium Account To Bank Account (Being premium paid to acquire stock option)	Dr.	2,000	 2,000
	Equity Stock Option Margin Account To Bank Account (Being initial margin paid on option)	Dr.	12,000	 12,000
August, 2011	(i) Option is setted by delivery of assets Equity shares of ABC Ltd. Account To Equity Stock Option Margin Account To Bank Account (Being option exercised and shares acquired. Margin adjusted and the balance amount was paid)	 Dr.	 25,000	 12,000 13,000
	Profit and loss Account To Equity Stock Option Premium Account (Being the premium transferred to profit and loss account on exercise of option)	Dr.	2,000	
	Bank Account To Equity Stock Option Margin Account (Being margin on equity stock option received back on exercise /expiry of option)	Dr.	12,000	 12,000

Illustration 6

X Ltd is a company engaged in the business of manufacturing white & rose wine. The process of manufacturing white & rose wine takes around 2 years. Due to this reason X Ltd has prepared its financial statements considering its operating cycle as 2 years, and accordingly classified the raw material purchased & held in stock for less than 2 years as current asset. Comment on the accuracy of the decision and the treatment of asset by X Ltd as per Revised Schedule VI (Now Schedule III to the companies Act, 2013)?

Solution

As per Revised Schedule VI (Now Schedule III to the companies Act, 2013), one of the criteria for classification of an asset as a current asset is that the asset is expected to be realised in the company's' operating cycle or is intended for sale or consumption in the company's normal operating cycle.

Further, Revised Schedule VI (Now Schedule III to the companies Act, 2013) defines that an operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. However, when the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

As per the facts given in the question, the process of manufacturing of lotus wine takes around 18 months; therefore, its realisation into cash and cash equivalents will be done only when it is ready for sale i.e. after 18 months. This means that normal operating cycle of the product is 18 months. Therefore, the contention of the company's management that the operating cycle of the product lotus wine is 18 months and not 12 months is correct.

Illustration 7

Combine Ltd. is a group engaged in manufacture and sale of industrial and consumer products. One of its division deals with the real estate. The real estate division is continuously engaged in leasing of real estate properties. The accountant showed the rent arising from leasing of real estate as 'other income' in the Statement of Profit and Loss. State, whether the classification of the rent income made by the accountant is correct or not in light of Revised Schedule VI (Now Schedule III to the companies Act, 2013) to the Companies Act, 1956?

Solution

As per para 4 of the 'General Instructions for preparation of Statement of Profit and Loss' given in the Revised Schedule VI (Now Schedule III to the companies Act, 2013) to the Companies Act, 1956, 'other income' does not include operating income. However, rent income arising from leasing of real estate properties is an operating income as Real Estate is one of the divisions of Combine Ltd. There is a separate head for operating income i.e. 'Revenue from Operations'. Therefore, classification of rent income as 'Other income' in the Statement of Profit and Loss will not be correct. It would infact be shown under the heading 'Revenue from Operations' only.

Illustration 8

Presented below is an extract of the Schedule of Secured and Unsecured Loans of Annual Report 2010-11 of Super Star Ltd.

Particulars	*Schedule No*	*As at 31st Mar'2011 (₹)*
Loan Funds		
a) Secured Loans	*3*	*6,07,114*
b) Unsecured Loans - Short Term		
- Banks		*36,112*
		6,43,226
Schedule 3: Secured Loans		
Term Loans from:		
- Banks		*2,95,002*
- Others		*3,12,112*
		6,07,114
Other Information:		
Current maturities of long-term loan from bank	*₹ 30,000*	
Current maturities of long-term loan from other parties	*₹ 15,376*	

There was no interest accrued/due as at end of the year.

Prepare appropriate note to accounts complying with the requirements of Revised Schedule VI (Now Schedule III to the companies Act, 2013) on the basis of available information.

Solution

Balance Sheet of Super Star Ltd.
As on 31st Mar'2011

Particulars	Note No	Amount
Non Current Liabilities		
Long term borrowings	4	5,61,738
Current Liabilities		
Short term borrowings	5	36,112
Other current liabilities	6	45,376
		6,43,226

Notes to Accounts

4.	Long-Term Borrowings	
	Term loans – Secured	
	- from banks	2,95,002
	- from other parties	3,12,112
		6,07,114
	Less : Shown in current maturities of long-term debt (Refer Note 6)	(45,376)
		5,61,738
5.	Short-Term Borrowings	
	(Unsecured – payable on demand)	
	- from bank	36,112
6.	Other Current Liabilities	
	Current maturities of long-term debt	
	From banks	30,000
	From other	15,376
		45,376

It is assumed the Note 1 is for 'Significant Accounting Policies', Note 2 for 'Share Capital', Note 3 for 'Reserves and Surplus'.

Illustration 9

Astha Ltd. has FCCBs worth ₹ 100 crore which are due to mature on 31st December 2013. While preparing the financial statements for the year ending 31st March 2013, it is expected that the FCCB holders will not exercise the option of converting the same to equity shares. How should the company classify the FCCBs on 31st March 2013? Will your answer be different if the company expects that FCCB holders will convert their holdings into equity shares of Astha Ltd.?

Answer

Revised Schedule VI (Now Schedule III to the companies Act, 2013) provides that:

"A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments and do not affect its classification."

In the present situation, Astha Ltd. does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date. The position will be same even when the FCCB holders are expected to convert their holdings into equity shares of Astha Ltd. Expectations cannot be called as unconditional rights. Thus, in both the situations, Astha Ltd. should classify the FCCBs as current liabilities as on 31 March 2013.

Illustration 10

The Balance Sheet of Appropriate Ltd. as at 31st March, 2013 is as follows:

	Note No.	*31st March, 2013*	*31st March, 2012*
Equity & Liabilities			
Share Capital	1	XXX	XXX
Reserves and Surplus	2	0	0
Employee stock option outstanding	3	XXX	XXX
Share application money refundable	4	XXX	XXX
Non-Current Liabilities			
Deferred tax liability (Arising from Indian Income Tax)	5	XXX	XXX

Current Liabilities			
Trade Payables	6	XXX	XXX
Total		XXXX	XXXX
Assets			
Non-Current Assets			
Fixed Assets -Tangible	7	XXX	XXX
Capital Work in progress (including capital advances)	8	XXX	XXX
Current Assets			
Trade Receivables	9	XXX	XXX
Deferred Tax Asset (Arising from Indian Income Tax)	10	XXX	XXX
Profit and Loss (Debit balance)		XXX	XXX
Total		XXXX	XXXX

Comment on the presentation in terms of Revised Schedule VI (Now Schedule III to the companies Act, 2013) and Accounting Standards notified by the Central Government.

Answer

(1) Share Capital' and 'Reserves and Surplus' are required to be shown under the heading "Shareholders' funds", which have not been shown in the given balance sheet. Although it is a part of 'Equity and Liabilities' yet it must be shown under the head "Shareholders' Funds". The heading "Shareholders' Funds" is missing in the balance sheet given in the question.

(2) Reserves & Surplus is showing zero balance, which is not correct since there is. Debit balance of Statement of Profit & Loss. This debit balance of Profit and Loss should be shown as a negative figure under the head 'Surplus'. The balance of 'Reserves and Surplus', after adjusting negative balance of surplus shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative. It should be noted that Profit and Loss Debit Balance is not a part of current assets rather debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus' as per requirement of Revised Schedule VI (Now Schedule III to the companies Act, 2013).

(3) As per Revised Schedule VI (Now Schedule III to the companies Act, 2013) Employee Stock Option Outstanding A/c is part of Reserves and Surplus and should not be shown separately. Classification of Reserves and Surplus should be reflected is 'Notes to Accounts' for the same.

(4) Share application money refundable shall be shown by way of note under the sub-heading "Other Current Liabilities". As this is refundable and not pending for allotment, hence it is not a part of equity.

(5) Deferred Tax Liabilities has been correctly shown under Non-Current Liabilities. But Deferred tax assets and deferred tax liabilities, both, can not be shown in balance sheet because only the net balance of Deferred Tax Liabilities or Asset is to be shown as per para 29 of AS 22, Appropriate Ltd. should offset Deferred Tax Asset & Deferred Tax Liabilities and the break up of Deferred Tax Asset & Deferred Tax Liabilities into major components of the respective balance should be

disclosed in 'Notes to Account'. Deferred Tax Asset shall be shown under Non-Current Asset. It should be the net balance of Deferred Tax Asset after adjusting the balance of deferred tax liability.

(6) Under the main heading of Non-Current Assets, Fixed Assets are further classified as under:

(i) Tangible assets

(ii) Intangible assets

(iii) Capital work in Progress

(iv) Intangible assets under development.

Keeping in view the above, the Capital Work-in Progress shall be shown under Fixed Assets as Capital Work in Progress. The amount of Capital advances included in CWIP shall be disclosed under the sub-heading "Long term loans and advances" under the heading Non-Current Assets.

Reference: The students are advised to refer the full text of relevant Guidance Notes.