CA INTER

ADVANCED ACCOUNTING

Question Bank

MODULE - 2

Confidence
Actions
Success

ADVANCED ACCOUNTING INDEX

01 FS of Companies 01

02 Cash Flow Statements (AS - 3) 54

03 Buy-Back of Securities 117

04 Amalgamation (AS - 14) 154

05 Internal Reconstruction 266

06 Accounting For Branches 323

07 Consolidated FS (AS - 21, 23 & 27) 388

08 Introduction To AS 482

09 Framework For Preparation And Presentation Of FS 486

10 Accounting Standards 499

AS - 1 504

AS - 2 514

AS - 4 530

AS - 5 539

AS - 7 551

AS - 9 567

AS - 10 583

AS - 11 606

AS - 12 617

AS - 13 633

AS - 15 668

AS - 16 678

AS - 17 696

AS - 18 709

AS - 19 723

AS - 20 739

AS - 22 757

AS - 24 766

AS - 25 773

AS - 26 784

AS - 28 795

AS - 29 806

No. of Questions

*ICAI SM Includes Illustrations, Theoretical, Scenario Based

Chapter No.	Chapter Name	Questions as per ICAI SM*	Questions from MRP
1	Financial Statements of Companies	11	11
2	Cash Flow Statements	33	13
3	Buy-Back of SecuritiesBuy-Back of Securities	11	6
4	Amalgamation Of Companies	26	19
5	Internal Reconstruction	14	8
6	Accounting For Branches	31	14
7	Consolidated FS (AS - 21, 23 & 27)	35	12
8	Introduction To Accounting Standards	3	3
9	Framework For Preparation And Presentation Of FS	8	8
10	Accounting Standards	5	3

Accounting Standards

	Questions as per ICAI SM	Questions from MRP		Questions as per ICAI SM	Questions from MRP
AS - 1	8	5	AS - 16	11	10
AS - 2	9	12	AS - 17	13	2
AS - 4	9	4	AS - 18	16	8
AS - 5	7	10	AS - 19	12	6
AS - 7	13	6	AS - 20	15	9
AS - 9	11	11	AS - 22	9	2
AS - 10	29	7	AS - 24	4	3
AS - 11	12	2	AS - 25	11	1
AS - 12	14	7	AS - 26	12	7
AS - 13	19	15	AS - 28	10	2
AS - 15	13	2	AS - 29	6	9

Total No. of Questions: 677 Questions

ICAI SM - 440 Questions

MRP Category - 237 Questions

[Covered up to Sept 2025 Attempt - All Resources]

10. Accounting Standards

Applicability Of Accounting Standards

Test Your Knowledge

1. **Non-corporate entities which are not Level I entities whose turnover (excluding other income) exceeds rupees __but does not exceed rupees two-fifty crores in the immediately preceding accounting year are classified as Level II entities.**
   (a) five crores.
   (b) two crores.
   (c) fifty crores.
   (d) ten crores.

2. **The following Accounting Standard is not applicable to Non-corporate Entities falling in Level II in its entirety**
   (a) AS 10.
   (b) AS 17.
   (c) AS 2.
   (d) AS 13.

3. **All non-corporate entities engaged in commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees 250 crores in the immediately preceding accounting year, are classified as**
   (a) Level II entities.
   (b) Level I entities.
   (c) Level III entities.
   (d) Level IV entities.

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4. **All non-corporate entities engaged in commercial, industrial or business activities having borrowings (including public deposits) in excess of rupees two crores but does not exceed rupees ten crores at any time during the immediately preceding accounting year.**
   (a) Level II entities.
   (b) Level IV entities.
   (c) Level III entities.
   (d) Level I entities.

5. **"Small and Medium Sized Company" (SMC) means, a company-**
   (a) which may be a bank, financial institution or an insurance company.
   (b) whose turnover (excluding other income) does not exceed rupees two-fifty crores in the immediately preceding accounting year;
   (c) whose turnover (excluding other income) does not exceed rupees fifty crores in the immediately preceding accounting year;
   (d) whose turnover (excluding other income) does not exceed rupees five hundred crores in the immediately preceding accounting year.

Answers to the Multiple-Choice Questions

1	(c)	2	(b)	3	(b)	4	(c)	5	(b)

Theoretical Questions

6. What are the issues with which Accounting Standards deal?

Answer:

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) Disclosure requirements.

7. List the criteria to be applied for rating a non - corporate entity as Level I entity and Level II entity for the purpose of compliance of Accounting Standards in India.

Answer:

Refer para 1.2.1 for Criteria to be applied for rating a non-corporate entity as Level-I entity and Level II entity for the purpose of compliance of Accounting Standards in India.

8. List the criteria to be applied for rating a non corporate entity as Level IV entity for the purpose of compliance of Accounting Standards in India.

Answer:

Refer para 1.2.1 for Criteria to be applied for rating a non-corporate entity as Level IV entity for the purpose of compliance of Accounting Standards in India.

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Scenario Based Question

9. XYZ Ltd. with a turnover of Rs.50 crores during previous year and borrowings of Rs.1 crore during any time in the previous year wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3.20X1. Advise the management on the exemptions that are available as per the Companies (Accounting Standards) Rules 2021.

Answer:

The question deals with the issue of Applicability of Accounting Standards for corporate entities.

The companies can be classified under two categories viz SMCs and Non SMCs under the Companies (Accounting Standards) Rules, 2021.

As per the Companies (Accounting Standards) Rules, 2021, criteria for above classification as SMCs, are:

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

- 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;
- which is not a bank, financial institution or an insurance company;
- whose turnover (excluding other income) does not exceed rupees two- fifty crores in the immediately preceding accounting year;
- which does not have borrowings (including public deposits) in excess of rupees fifty crores at any time during the immediately preceding accounting year; and
- which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Since, XYZ Ltd.'s turnover was Rs.50 crores which does not exceed Rs.250 crores and borrowings of Rs.1 crore are less than Rs.50 crores, it is a small and medium sized company (SMC).

10. A company was classified as Non-SMC in 20X1 - X2. In 20X2 - X3, it has been classified as SMC. The management desires to avail the exemptions or relaxations available for SMCs in 20X2 - X3. However, the accountant of the company does not agree with the same. Comment.

Answer:

As per Companies (Accounting Standards) Rules, 2021, an existing company, which was previously not a SMC and subsequently becomes a SMC, should not be qualified for exemption or relaxation in respect of accounting standards available to a SMC until the company remains a SMC for two consecutive accounting periods. Therefore, the management of the company cannot avail the exemptions/ relaxations available to the SMCs for the FY 20X2-X3.

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1:

(a) A company with a turnover of Rs.225 crores and borrowings of Rs.51 crore during the year ended 31st March, 2021, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3. 2021. Advise the management on the exemptions that are available as per the Companies (Accounting Standards) Rules, 2021.

(b) An organization whose objects are charitable or religious, believes that the Accounting Standards are not applicable to it since only a very small proportion of its activities are business in nature. Comment. (RTP May '22)

Answer :

(a) The question deals with the issue of Applicability of Accounting Standards for corporate entities. The companies can be classified under two categories viz SMCs and Non-SMCs under the Companies (Accounting Standards) Rules, 2021. As per the Companies (Accounting Standards) Rules, 2021, criteria for above classification as SMCs, are:

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

- 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;
- which is not a bank, financial institution or an insurance company;
- whose turnover (excluding other income) does not exceed rupees two-fifty crores in the immediately preceding accounting year;
- which does not have borrowings (including public deposits) in excess of rupees fifty crores at any time during the immediately preceding accounting year; and
- which is not a holding or subsidiary company of a company which is not a small and medium-sized company. Since, XYZ Ltd.'s turnover was Rs.225 crores which does not exceed Rs.250 crores but borrowings of Rs.51 crore are more than Rs.50 crores, it is not a small and medium sized company (SMC). The exemptions available to SMC are not available to this company.

(b) Accounting Standards apply in respect of any enterprise (whether organized in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes. Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.

Question 2: 4. As per the revised scheme effective from accounting periods commencing on or after April 1, 2024, classify non company entities for the purpose of applicability of Accounting Standards. Briefly explain the criteria for each category.

Answer:

The revised scheme for applicability of Accounting Standards to Non-company entities shall come into effect in respect of accounting periods commencing on or after April 1, 2024, which is as under:

1. For the purpose of applicability of Accounting Standards, Non-company entities are classified into two categories, viz., Micro, Small and Medium Sized Entities (MSMEs) and Large entities.

2. Micro, Small and Medium Sized Entity (MSME) means, a non-company entity:
   (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 two hundred and fifty crore rupees in the immediately preceding accounting year;
   (iv) which does not have borrowings in excess of fifty crore rupees at any time during the immediately preceding accounting year; and
   (v) which is not a holding or subsidiary of an entity which is not a micro, small and medium-sized entity.
   Explanation.- For the purposes of this clause, a non-company entity shall qualify as a Micro, Small and Medium Sized entity, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.
   Large entity is a non-company entity that is not an MSME.
   The terms 'Small and Medium Enterprise' and 'SME' used in Accounting Standards shall be read as 'Micro, Small and Medium size entity' and 'MSME', respectively. Further, the terms Level II, Level III and Level IV entities used in Accounting Standards shall be read as 'Micro, Small and Medium Sized Entity' and Level I entity shall be read as a 'Large' entity

Question 3: What are Accounting Standards? Explain the objectives of "Accounting Standards" in brief also state the advantages of setting Accounting Standards. (PYP Sept 25 4 Marks)

Answer:

Accounting Standards are the written policy documents issued by Government relating to various aspects of measurement, treatment, presentation and disclosure of accounting transactions and events.

Following are the objectives of Accounting Standards:

a. Accounting Standards harmonize the diverse accounting policies and practices followed by different companies in India.
b. Accounting Standards facilitates the preparation of financial statements and make them comparable.
c. Accounting Standards give a sense of faith and reliability to the users.

The main advantage of setting accounting standards are as follows:

a. Accounting Standards makes the financial statements of different companies comparable which helps investors in decision making.
b. Accounting Standards prevent any misleading accounting treatment.
c. Accounting Standards prevent manipulation of data by the management.

AS – 1: Disclosure of Accounting Policies

Illustrations

Illustration 1

In the books of M/s Prashant Ltd., closing inventory as at 31.03.20X2 amounts to Rs.1,63,000 (on the basis of FIFO method).

The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 20X1-X2. On the basis of weighted average method, closing inventory as on 31.03.20X2 amounts to Rs.1,47,000.

Realisable value of the inventory as on 31.03.20X2 amounts to Rs.1,95,000. Discuss disclosure requirement of change in accounting policy as per AS-1.

Solution:

As per AS 1"Disclosure of Accounting Policies", any change in an accounting policy which has a material effect should be disclosed in the financial statements. 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. Thus Prashant Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realizable value. Since net realizable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e. 20X1-X2, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by Rs.16,000.

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Illustration 2

Jagannath Ltd. had made a rights issue of shares in 20X2. In the offer document to its members, it had projected a surplus of Rs.40 crores during the accounting year to end on 31st March, 20X2. 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 Rs.10 crores. The board in consultation with the managing director, decided on the following:

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

(ii) Provide for permanent diminution in the value of investments, which had taken place over the past five years, the amount of provision being Rs.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 20X1-20X2.

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 Rs.50 crores and the profit for the year has increased by Rs.20 crores.

(ii) The company has decided to provide Rs.10 crores for the permanent diminution 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 Rs.10 crores.

Illustration 3

XYZ Company is engaged in the business of financial services and is undergoing tight liquidity position, since most of the assets of the company are blocked in various claims/petitions in a Special Court. XYZ has accepted Inter-Corporate Deposits (ICDs) and it is making its best efforts to settle the dues. There were claims at varied rates of interest, from lenders, from the due date of ICDs to the date of repayment. The company has provided interest, as per the terms of the contract till the due date and a note for non-provision of interest on the due date to date of repayment was affected in the financial statements. On account of uncertainties existing regarding the determination of the amount and in the absence of any specific legal obligation at present as per the terms of contracts, the company considers that these claims are in the nature of "claims against the company not acknowledged as debt", and the same has been disclosed by way of a note in the accounts instead of making a provision in the statement of profit and loss. State whether the treatment done by the Company is correct or not.

Solution:

AS 1 'Disclosure of Accounting Policies' recognises 'prudence' as one of the major considerations governing the selection and application of accounting policies. 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.

Also as per AS 1, 'accrual' is one of the fundamental accounting assumptions.

Irrespective of the terms of the contract, so long as the principal amount of a loan is not repaid, the lender cannot be replaced in a disadvantageous position for nonpayment of interest in respect of overdue amount. From the aforesaid, it is apparent that the company has an obligation on account of the overdue interest. In this situation, the company should provide for the liability (since it is not waived by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case. However, in respect of the overdue interest amounts, which are settled, the liability should be accrued to the extent of amounts settled.

Non-provision of the overdue interest liability amounts to violation of accrual basis of accounting. Therefore, the treatment, done by the company, of not providing the interest amount from due date to the date of repayment is not correct.

Test Your Knowledge

1. **Which of the following is NOT a major consideration in selection and application of accounting policies?**
   (a) Prudence
   (b) Comparability
   (c) Materiality
   (d) Substance over form

2. **Adoption of different accounting policies by different companies operating in the same industry affects which of the qualitative characteristics the most?**
   (a) Comparability
   (b) Relevance
   (c) Faithful representation
   (d) Reliability

3. **Which of the following statement would not be correct in relation to disclosures to be made in the financial statements after making any change in an accounting policy?**
   (a) Any change in an accounting policy which has a material effect should be disclosed.
   (b) The amount by which any item in the financial statements is affected by such change should be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
   (c) 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

Answers to the Multiple Choice Questions

1	(b)	2	(a)	3	(d)

Theoretical Questions

4. What are the three fundamental accounting assumptions recognised by Accounting Standard (AS) 1? Briefly describe each one of them.

Answer:

Accounting Standard (AS) 1 recognises three fundamental accounting assumptions. These are: (i) Going Concern; (ii) Consistency; and (iii) Accrual basis of accounting.

5. Has Accounting Standard 1 prescribed the manner in which the accounting policies followed by the entity should be disclosed?

Answer:

Paras 18-20 of Accounting Standard 1, Disclosure of Accounting Policies, lay down the manner in which accounting policies have to be disclosed, which is stated as under:

- 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. by stakeholders, analysts, investors etc. To mitigate the loss of comparability, Accounting Standard 1, Disclosure of Accounting Policies requires disclosure of significant accounting policies as a part of the financial statements. This would help users of the financial statements to understand the policies followed by different entities, particularly if they belong to the same industry, and make a correct analysis of each entity resulting in more informed decision-making.

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Scenario Based Questions

6. State whether the following statements are 'True' or 'False'. Also give reason for your answer.

(i) Certain fundamental accounting assumptions underline the preparation and presentation of financial statements. They are usually specifically stated because their acceptance and use are not assumed.

(ii) If fundamental accounting assumptions are not followed in presentation and preparation of financial statements, a specific disclosure is not required.

(iii) All significant accounting policies adopted in the preparation and presentation of financial statements should form part of the financial statements.

(iv) Any change in an accounting policy, which has a material effect should be disclosed. Where the amount by which any item in the financial statements is affected by such change is not ascertainable, wholly or in part, the fact need not to be indicated.

Answer:

(i) False; As per AS 1 "Disclosure of Accounting Policies", certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

(ii) False; As per AS 1, 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.

(iii) True; 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. The disclosure of the significant accounting policies as such should form part of the financial statements and they should be disclosed in one place.

(iv) False; 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. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

7. Give examples of areas where accounting policies adopted could be different for different enterprises. Would there be any adverse impact due to the adoption of different policies and if yes how does Accounting Standard 1 seek to address such issue?

Answer:

There are various areas where different accounting policies could be adopted by different entities within the same industry. An entity may choose to value its inventories using FIFO method, whereas another entity may choose to value the same using Weighted Average method.

While an entity is free to choose its accounting policy as long as in the financial statements reflect 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, the application of different accounting policies by different entities affects the comparability of the financial statements of such different entities by stakeholders, analysts, investors etc. To mitigate the loss of comparability, Accounting Standard 1, Disclosure of Accounting Policies requires disclosure of significant accounting policies as a part of the financial statements. This would help users of the financial statements to understand the policies followed by different entities, particularly if they belong to the same industry, and make a correct analysis of each entity resulting in more informed decision-making.

8. **ABC Ltd. was making provision for non-moving inventories based on issues for the last 12 months up to 31.3.20X1.**

The company wants to provide during the year ending 31.3.20X2 based on technical evaluation:

Total value of Inventory	**Rs.100 lakhs**
Provision required based on 12 months issue	**Rs.3.5 lakhs**
Provision required based on technical evaluation	**Rs.2.5 lakhs**

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

Answer:

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.

The decision of making provision for non-moving inventories on the basis of technical evaluation does not amount to change in accounting policy.

In the above case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from Rs.3.5 lakhs to

Rs.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 20X1-X2:

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

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: HIL Ltd. was making provision for non-moving stocks based on no issues having occurred for the last 12 months up to 31.03.2019. The company now wants to change it and make provision based on technical evaluation during the year ending 31.03.2020. Total value of stock on 31.3.20 is Rs. 120 lakhs. Provision required based on technical evaluation amounts Rs. 3.00 lakhs. However, provision required based on 12 months (no issues) is Rs. 4.00 lakhs. You are required to discuss the following points in the light of Accounting Standard (AS)-1:

(i) Does this amount to change in accounting policy?

(ii) Can the company change the method of accounting?

(iii) Explain how it will be disclosed in the annual accounts of HIL Ltd. for the year 2019-20.

(MTP April '22, MTP April '23) (MTP Mar'23, RTP Nov '23, RTP May '25)

Answer:

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 but the basis for making provision will not constitute accounting policy. 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 Rs. 4 lakhs to Rs. 3 lakhs are 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 HIL Ltd. for the year 2019-20 in the following manner:

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

Question 2: In the books of Rani Ltd., closing inventory as on 31.03.2020 amounts to ₹1,75,000 (valued based on FIFO method). The Company decides to change from FIFO method to weighted average method for ascertaining the costs of inventory from the year 2019-20. On the basis of weighted average method, closing inventory as on 31.03.2020 amounts to ₹1,59,000. Realizable value of the inventory as on 31;03;2020 amounts to ₹2,07 ,000. Discuss disclosure requirements of change in accounting policy as per AS 1.(RTP May 23)

Answer:

As per AS 1 "Disclosure of Accounting Policies", any change in an accounting policy which has a material effect should be disclosed in the financial statements. 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. Thus Rani Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose the change in accounting policy in the following manner:

"The company values its inventory at lower of cost and net realizable value. Since net realizable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e. 2019-20, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by ₹16,000 (1,75,000 - 1,59,000)."

Question 3: Kumar Ltd. had made a rights issue of shares in 2017. In the offer document to its members, it had projected a surplus of Rs. 40 crores during the accounting year to end on 31 st March, 2017. 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 Rs. 10 crores. The board in consultation with the managing director, decided 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 Rs. 600 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 2016-2017 (MTP Oct'22)

Answer:

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:

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 Rs. 12 crores than would have been the case if the old policy were to continue.

Question 4: You are required to comment on the following cases as per the provisions of Accounting Standard-1 'Disclosure of Accounting Policies':

(1) Bee Limited has not complied with AS-2 "Valuation of inventories" and the same is disclosed in the Notes on Accounts. Management is of the view that the financial statements give a true and fair view as non-compliance with AS-2 is disclosed.

(2) Cee Limited sold its Office Building for Rs.10,00,000 on 1st March, 2023. The buyer has paid the full amount and taken possession of the building. The book value of the Office Building is Rs.4,00,000. On 31st 2023, documentation and legal formalities are pending. The company has not recorded the disposal and the amount received is shown as an advance.

(3) Dee Limited has prepared its accounts on cash basis and the same is not disclosed.

(4) Jee Limited disclosed significant accounting policies adopted in the preparation of financial statements, in the Directors' Report. (PYP May '23)

Answer:

(1) As per AS–I disclosure of accounting policies is not a remedy for wrong or inappropriate treatment in accounting. In the given case the financial statement does not give a true and fair view as they are not in compliance with AS–2.

(2) Considering the substance over form as per AS–I, documentation and legal formalities represent the form of the transaction, although the legal title has not been transferred, the economic reality and substance are that the rights and beneficial interest in the Office Building have been transferred. Therefore, recording of acquisition/ disposal (by the transferee and transferor

respectively) would in substance represent the transaction entered into.

(3) Accrual is a fundamental accounting assumption. If it is not followed by the company, the facts should be disclosed under AS–I. Hence the company should disclose the fact that the cash basis of accounting has been followed in the notes on accounts.

(4) The practice followed by the company is not correct. It should be disclosed as part of financial statements (The director's report is not part of financial statements).

Question 5: Lion Ltd., engaged in manufacturing and construction contracts, prepares its financial statements for the year ended 31st March 2025. The company follows historical cost for fixed assets, FIFO for inventory valuation, and percentage of completion method for revenue recognition in construction contracts. During the year, the management changes:

- **The inventory valuation method from FIFO to Weighted Average due to volatility in raw material prices.**
- **The depreciation method from Straight Line Method (SLM) to Written Down Value (WDV) citing better reflection of asset usage.**

The company discloses the change in inventory method in notes, but does not disclose the change in depreciation method, stating that it is not material.

Additionally, the company has not disclosed its accounting policy on recognition of government grants, though it has received a significant subsidy this year.

You are required to:

(a) Identify and explain violations (if any) of AS 1 in the above case.

(b) Critically evaluate whether "materiality" can be used as a justification for non-disclosure of a change in accounting policy.

(c) Justify, would the change from FIFO to Weighted Average be treated as a change in accounting estimate or accounting policy under AS 1?

Answer:

As per AS 1 "Disclosure of Accounting Policies", the following requirements are relevant:

a. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

b. Any change in an accounting policy which has a material effect should be disclosed along with the nature and reasons for such change.

c. If the effect of such change is not ascertainable wholly or in part, the fact should be indicated.

Application to Lion Ltd.:

(a)

1. Change in Inventory Valuation Method (FIFO to Weighted Average): This is a change in accounting policy. The company has disclosed the change in the notes to accounts along with justification, which is in line with the disclosure requirements of AS 1, provided the impact of the change is also disclosed or indicated as unascertainable if applicable.
2. **Change in Depreciation Method (SLM to WDV):** As per AS 10 (Revised), a change in the method of depreciation is considered a change in accounting estimate. However, AS 1 also requires disclosure of material items affecting financial statements. Depreciation affects key financial figures such as profit, asset value, and return ratios. Even if the change is classified as an estimate, if it has a material effect, disclosure is warranted. The company's decision not to disclose the change on the grounds of immateriality may not be appropriate unless supported by clear quantitative evidence.
3. **Non-Disclosure of Accounting Policy for Government Grants:** Lion Ltd. has received a

significant subsidy during the year but has not disclosed its accounting policy for government grants. As per AS 1, all significant accounting policies, including those for government grants, should be disclosed. Hence, non-disclosure amounts to a violation of AS 1.

(b) Evaluation of "Materiality" as Justification for Non-Disclosure

AS 1 emphasizes that accounting policies that are significant and changes that materially affect the financial statements should be disclosed.

- Materiality is assessed in terms of the potential of an item or change to influence economic decisions of users.
- Change in the method of depreciation affects not only profit and loss but also asset values and tax liabilities. Thus, even if the quantitative impact appears small, its qualitative impact (e.g., on comparability and trend analysis) may be significant.
- Therefore, the company's reliance on "materiality" as a justification for non-disclosure is not valid unless there is concrete evidence showing the impact is indeed immaterial both quantitatively and qualitatively.

(c) Nature of Change from FIFO to Weighted Average

The change from FIFO to Weighted Average should be treated as a change in accounting policy and not a change in accounting estimate under AS 1, and its nature and financial impact should be properly disclosed in the financial statements.

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AS – 2: Valuation of Inventory

Illustrations

Illustration 1

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 20 X1-X2, the Historical Cost and Net Realisable Value of the items of closing stock are determined as follows:

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

What will be the value of closing stock?

Solution:

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

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

Hence, closing stock will be valued at Rs.76 lakhs.

Illustration 2

X Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 20X1. Till March, 20X2, 75% of the stocks were sold. The company wants to disclose closing stock at 10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.20X2.

Solution:

As per AS 2 (Revised) "Valuation of Inventories", the inventories are to be valued at lower of cost or net realisable value.

In this case, the cost of inventory is Rs.10 lakhs. The net realisable value is 11,00,000 x 90% = Rs.9,90,000. So, the stock should be valued at Rs.9,90,000.

Illustration 3

In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in wastage of 300 MT. Cost per MT of input is Rs.1,000. The entire quantity of waste is on stock at the year end. State with reference to Accounting Standard, how will you value the inventories in this case?

Solution:

As per AS 2 (Revised), abnormal amounts of wasted materials, labour and 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 (50 MT x 1,052.6315 = Rs.52,632) will be charged to the profit and loss statement.

Cost per MT (Normal Quantity of 4,750 MT) = 50,00,000 / 4,750 = Rs.1,052.6315

Total value of inventory = 4,700 MT x Rs.1,052.6315 = Rs.49,47,368.

Illustration 4

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

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

Fixed production charges for the year on normal working capacity of 2 lakh kgs is Rs.20 lakhs. 4,000 kgs of finished goods are in stock at the year end.

Solution:

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

Cost per kg. of finished goods:

		Rs.
Material Cost		200
Direct Labour	40	
Direct Variable Production Overhead	20	
Fixed Production Overhead (20,00,000 / 2,00,000)	10	70
		270

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

Test Your Knowledge

1. **Which item of inventory is under the scope of AS 2 (Revised)?**
   - **(a)** WIP arising under construction contracts
   - **(b)** Raw materials
   - **(c)** Shares
   - **(d)** Debentures held as stock in trade.

2. **Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be**
   - **(a)** sold at or above cost.
   - **(b)** sold above cost.
   - **(c)** sold less than cost.
   - **(d)** sold at market value(where market value is more than cost).

3. **All of the following costs are excluded while computing value of inventories except?**
   - **(a)** Selling and Distribution costs
   - **(b)** Allocated fixed production overheads based on normal capacity.
   - **(c)** Abnormal wastage
   - **(d)** Storage costs (which is not necessary part of the production process)

4. **Identify the statement(s) which is/are incorrect.**
   - **(a)** Storage costs which is a necessary part of the production process is included in inventory valuation.
   - **(b)** Administration overheads are never included in inventory valuation.
   - **(c)** Full amount of variable production overheads incurred are included in inventory valuation.
   - **(d)** Administration overheads are always included in inventory valuation.

Answer to the Multiple Choice Questions

1.	(b)	2.	(a)	3.	(b)	4.	(b)

Theoretical Questions

5. "In determining the cost of inventories it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred". Provide examples of such costs as per AS 2 (Revised) 'Valuation of Inventories'.

Answer:

As per AS 2 (Revised) 'Valuation of Inventories', certain costs are excluded from the cost of the inventories and are recognised as expenses in the period in which incurred. Examples of such costs are:

(a) abnormal amount 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.

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Scenario Based Questions

6. Capital Cables Ltd., has a normal wastage of 4% in the production process. During the year 20X1-20X2 the Company used 12,000 MT of raw material costing Rs.150 per MT. At the end of the year 630 MT of wastage was in stock. The accountant wants to know how this wastage is to be treated in the books. Explain in the context of AS 2 (Revised) the treatment of normal loss and abnormal loss and also find out the amount of abnormal loss, if any.
(MTP May 25 S1 4M, MTP May S2 5M)

Answer:

As per AS 2 (Revised) 'Valuation of Inventories', abnormal amounts of wasted materials, labour and other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred. The normal loss will be included in determining the cost of inventories (finished goods) at the year end.

Amount of Abnormal Loss:

Material used 12,000 MT @ Rs.150	=	Rs.18,00,000
Normal Loss (4% of 12,000 MT)		480 MT
Net quantity of material		11,520 MT
Abnormal Loss in quantity		150 MT

Abnormal Loss Rs.23,437.50 [150 units @ Rs.156.25 (Rs.18,00,000/11,520)]

Amount Rs.23,437.50 will be charged to the Statement of Profit and Loss.

7. Mr. Mehul gives the following information relating to items forming part of inventory as on 31-3-20X1. His factory produces Product X using Raw material A.
(i) 600 units of Raw material A (purchased @ Rs.120). Replacement cost of raw material A as on 31-3-20X1 is Rs.90 per unit.
(ii) 500 units of partly finished goods in the process of producing X and cost incurred till date Rs.260 per unit. These units can be finished next year by incurring additional cost of Rs.60 per unit.
(iii) 1500 units of finished Product X and total cost incurred Rs.320 per unit. Expected selling price of Product X is Rs.300 per unit.
Determine how each item of inventory will be valued as on 31-3-20X1. Also calculate the value of total inventory as on 31-3-20X1.

Answer:

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at cost 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. In the given case, selling price of product X is Rs.300 and total cost per unit for production is Rs.320.

Hence the valuation will be done as under:

(i) 600 units of raw material will be written down to replacement cost as market value of finished product is less than its cost, hence valued at Rs.90 per unit.

(ii) 500 units of partly finished goods will be valued at 240 per unit i.e. lower of cost (Rs.260) or Net realisable value Rs.240 (Estimated selling price Rs.300 per unit less additional cost of Rs.60).

(iii) 1,500 units of finished product X will be valued at NRV of Rs.300 per unit since it is lower than cost

Rs.320 of product X.

Valuation of Total Inventory as on 31.03.20X1:

	Units	Cost (Rs.)	NRV / Replacement cost	Value = units x cost or NRV whichever is less (Rs.)
Raw material A	600	120	90	54,000
Partly finished goods	500	260	240	1,20,000
Finished goods X	1,500	320	300	4,50,000
Value of Inventory				6,24,000

8. On 31st March 20X1, a business firm finds that cost of a partly finished unit on that date is Rs.530. The unit can be finished in 20X1 - X2 by an additional expenditure of Rs.310. The finished unit can be sold for Rs.750 subject to payment of 4% brokerage on selling price. The firm seeks your advice regarding the amount at which the unfinished unit should be valued as at 31st March, 20X1 for preparation of final accounts. Assume that the partly finished unit cannot be sold in semi finished form and its NRV is zero without processing it further.

Answer:

Valuation of unfinished unit

	Rs.
Net selling price	750
Less: Estimated cost of completion	(310)
	440
Less: Brokerage (4% of 750)	(30)
Net Realisable Value	410
Cost of inventory	530
Value of inventory (Lower of cost and net realisable value)	410

9. Alpha Ltd. sells flavored milk to customers; some of the customers consume the milk in the shop run by Alpha Limited. While leaving the shop, the consumers leave the empty bottles in the shop and the company takes possession of these empty bottles. The company has laid down a detailed internal record procedure for accounting for these empty bottles which are sold by the company by calling for tenders.
Keeping this in view:
Decide whether the inventory of empty bottles is an asset of the company;
If so, whether the inventory of empty bottles existing as on the date of Balance Sheet is to be considered as inventories of the company and valued as per AS 2 or to be treated as scrap and shown at realizable value with corresponding credit to 'Other Income'?

Answer:

As per the 'Framework on Presentation and Preparation of Financial Statements':

Tangible objects or intangible rights carrying probable future benefits, owned by an enterprise are called assets.

Alpha Ltd. sells these empty bottles by calling tenders. It means further benefits are accrued on its

sale.

Therefore, empty bottles are assets for the company.

As per AS 2, inventories are assets held for sale in the ordinary course of business.

Inventory of empty bottles existing on the Balance Sheet date is the inventory and Alpha Ltd. has detailed controlled recording and accounting procedure which duly signify its materiality.

Thus, inventory of empty bottles cannot be considered as scrap and should be valued as inventory in accordance with AS 2.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: An enterprise ordered 20,000 KG of certain material at ₹ 110 per unit. The purchase price includes GST ₹ 12 per KG, in respect of which full input tax credit (ITC) is admissible. Freight incurred amounted to ₹ 1,17,600. Normal transit loss is 2%. The enterprise actually received 19,500 KG and consumed 18,000 KG of the material.
You are required to calculate cost of material per KG; Allocation of material cost.
(RTP May 23)

Answer:

Calculation of Normal cost per Kg.

	₹
Purchase price (20,000 Kg; x ₹ 110)	22,00,000
Less: Input Tax Credit (20,000 Kg; x ₹ 12)	(2,40,000)
	19,60,000
Add: Freight	1,17,600
A. Total material cost	20,77,600
B. Number of units normally received = 98% of 20,000 Kg.	Kg. 19,600
C. Normal cost per Kg. (A/B)	106

Allocation of material cost

	Kg.	₹ /Kg.	₹
Materials consumed	18,000	106	19,08,000
Cost of inventory	1,500	106	1,59,000
Abnormal loss	100	106	10,600
Total material cost	19,600	106	20,77,600

Note: Abnormal losses are recognized as separate expense.

Question 2: In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in wastage of 300 MT. Cost per MT of input is Rs. 1,000. The entire quantity of waste and finished output is in stock at the year end. State with reference to Accounting Standard, how will you value the inventories in this case? What will be treatment for normal and abnormal waste? (MTP Apr'22 & April '23)

Answer:

As per para 13 of AS 2 (Revised), abnormal amounts of wasted materials, labour and other production costs are excluded from cost of inventories and such costs are recognized 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 l be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste (50 MT x 1,052.6315 = Rs. 52,632) will be charged to the profit and loss statement.

Cost per MT (Normal Quantity of 4,750 MT) = 50,00,000 / 4,750 = Rs. 1,052.6315 Total value of inventory = 4,700 MT x Rs. 1,052.6315 = Rs. 49,47,368.

Question 3:

(i) "In determining the cost of inventories, it is appropriate to exclude certain costs and recognize them as expenses in the period in which they are incurred". Provide examples of such costs as per AS 2 'Valuation of Inventories'.

(MTP 2.5 Marks April 21 & Oct '23, RTP May'22, Old & New SM)

(ii) X Limited purchased goods at the cost of Rs. 40 lakhs in October, 2020. Till March, 2021, 75% of the stocks were sold. The company wants to disclose closing stock at Rs. 10 lakhs. The expected sale value is Rs. 11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct value of closing stock to be disclosed as at 31.3.2021.

(MTP Oct '23)

Answer:

(i) As per AS 2 'Valuation of Inventories', certain costs are excluded from the cost of the inventories and are recognized as expenses in the period in which incurred. Examples of such costs are:

(a) abnormal amount 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.

(ii) As per AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value. In this case, the cost of inventory is Rs. 10 lakhs. The net realizable value is 11,00,000 Rs.90% = Rs. 9,90,000. So, the stock should be valued at Rs. 9,90,000.

Question 4: On the basis of information given below, find the value of inventory (by periodic inventory method) as per AS 2, to be considered while preparing the Balance Sheet as on 31st March, 2017 on weighted Average Basis.

Details of Purchases:

Date of purchase	Unit(Nos.)	Purchase cost per unit (Rs.)
01-03-2017	20	108
08-03-2017	15	107
17-03-2017	30	109
25-03-2017	15	107

Details of issue of Inventory:

Date of Issue	Unit(Nos.)
03-03-2017	10
12-03-2017	20
18-03-2017	10
24-03-2017	20

Net realizable value of inventory as on 31st March, 2017 is Rs. 107.75 per unit. You are required to compute the value of Inventory as per AS 2. **(RTP May'22)**

Answer:

Net Realizable Value of Inventory as on 31st March, 2017 = Rs. 107.75 x 20 units = Rs. 2,155 Value of inventory as per Weighted Average basis. Total units purchased and total cost:

01.03.2017	Rs. 108 x 20 units = Rs. 2160
08.3.2017	Rs. 107 x 15 units = Rs. 1605
17.03.2017	Rs. 109 x 30 units = Rs. 3270
25.03.2017	Rs. 107 x 15 units = Rs. 1605

Total 80 units = Rs. 8640

Weighted Average Cost = Rs. 8640/80 units = Rs.108 Total cost =Rs. 108 x 20 units = Rs. 2,160

Value of inventory to be considered while preparing Balance Sheet as on 31st March, 2017 is, Cost or Net Realizable value whichever is lower i.e. Rs. 2,155.

Question 5: U.S.A Ltd. purchased raw material @ ₹ 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in inventory. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realizable value of the raw material for valuation of inventories at the end of the year. However, replacement cost of raw material is ₹ 300 per kg. How will you value the inventory of raw material?

(MTP 5 Oct '22)

Answer:

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the inventory of raw material at ₹ 30,00,000 (10,000 kg; @ ₹ 300 per kg;);

Question 6: SM Enterprises is a leading distributor of petrol. A detailed inventory of petrol in hand is taken when the books are closed at the end of each month. For the month ending June 2021 following information is available:

(i) Sales for the month of June 2021 was ₹30,40,000.

(ii) General overheads cost ₹4,00,000.

(iii) Inventory at beginning 10,000 liters @ ₹ 92 per liter.

(iv) Purchases-June 1, 2021, 20,000 liters @ ₹ 90 per liter, June 30, 2021, 10,000 liters @ ₹ 95 per liter.

(v) Closing inventory 13,000 liters.

You are required to compute the following by FIFO method as per AS 2:

(i) Value of Inventory on 30th June, 2021.

(ii) Amount of cost of goods sold for June,2021.

(iii) Profit/Loss for the month of June,2021. **(PYP May '22)**

Answer:

	₹
Cost of closing inventory for 13,000 liters as on 30th June 2021	
10,000 liters @ ₹ 95	9,50,000
3,000 liters @ ₹ 90	2,70,000
Value of inventory (determined at cost in absence of NRV)	-
	12,20,000
Calculation of cost of goods sold	
Opening inventories (10,000 liters @ ₹ 92)	9,20,000
Purchases June – 1 (20,000 liters @ ₹ 90)	18,00,000
June – 30 (10,000 liters @ 95)	9,50,000
	36,70,000

Less: Closing inventories	(12,20,000)
Cost of Goods Sold	24,50,000
Calculation of Profit	
Sales (Given) (A)	30,40,000
Cost of Goods Sold	24,50,000
Add: General Overheads	4,00,000
Total Cost (B)	28,50,000
Profit (A–B)	1,90,000

Question 7: Alpha Ltd. sells flavoured milk to customers; some of the customers consume the milk in the shop run by Alpha Limited. While leaving the shop, the consumers leave the empty bottles in the shop and the company takes possession of these empty bottles. The company has laid down a detailed internal record procedure for accounting for these empty bottles which are sold by the company by calling for tenders. Keeping this in view:
Decide whether the inventory of empty bottles is an asset of the company;
If so, whether the inventory of empty bottles existing as on the date of Balance Sheet is to be considered as inventories of the company and valued as per AS 2 or to be treated as scrap and shown at realizable value with corresponding credit to 'Other Income'? (RTP Nov '23)

Answer:

As per the 'Framework on Presentation and Preparation of Financial Statements':

Tangible objects or intangible rights carrying probable future benefits, owned by an enterprise are called assets.

Alpha Ltd. sells these empty bottles by calling tenders. It means further benefits are accrued on its sale. Therefore, empty bottles are assets for the company.

As per AS 2, inventories are assets held for sale in the ordinary course of business.

Inventory of empty bottles existing on the Balance Sheet date is the inventory and Alpha Ltd. has detailed controlled recording and accounting procedure which duly signify its materiality.

Thus, inventory of empty bottles cannot be considered as scrap and should be valued as inventory in accordance with AS 2.

Question 8: Well Wear Limited is a Textile Manufacturing Company and engaged in the production of Polyester (P) and Nylon (N). While manufacturing the main products, a by-product Fiber (F) is also produced. Details of the cost of production are as under:
Purchase of Raw Material for manufacturing process of

30,000 units	**Rs. 3,50,000**
Wages paid	**Rs. 1,60,000**
Fixed overheads	**Rs. 1,20,000**
Variable overheads	**Rs. 60,000**
Output:	
Polyester (P)	**12,500 Units**
Nylon (N)	**10,000 Units**
Fiber (F)	**3,200 Units**
Closing Inventory:	
Polyester (P)	**1,600 Units**
Nylon(N)	**400 Units**

Average market price of Polyester and Nylon is Rs. 100 and Rs. 60 per unit respectively, by-product Fiber is sold@Rs. 40 per unit. There is a profit of Rs. 8,000 on sale of by-product after incurring separate processing expenses of Rs. 10,000 and packing charges of Rs. 9,000. Rs. 5,000 was realized from sale of scrap.

On the basis of the above information, you are required to compute the value of closing inventory of Polyester and Nylon. (PYP May 24 7M)

Answer:

As per 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.

Determination of value of closing inventory of Polyester and Nylon

	Polyester	Nylon
Closing inventory in units	1,600 units	400 units
Cost per unit	Rs. 31.14	Rs. 18.68
Value of closing inventory	Rs. 49,824	Rs. 7,472

Working Notes

1. **Calculation of net realizable value of by-product, Fiber**

		Rs.
Selling price of by-product Fiber	(3,200 units x Rs. 40 per unit)	1,28,000
Less: Separate processing charges of by-product Fiber		(10,000)
Packing charges		(9,000)
Net realizable value of by-product Fiber		1,09,000

2. **Calculation of cost of conversion for allocation between joint products Polyester and Nylon**

	Rs.	Rs.
Raw material		3,50,000
Wages		1,60,000
Fixed overhead		1,20,000
Variable overhead		60,000
		6,90,000
Less: NRV of by-product Fiber (W.N. 1)	(1,09,000)	
Sale value of scrap	(5,000)	(1,14,000)
Joint cost to be allocated between Polyester and Nylon		5,76,000

Determination of "basis for allocation" and allocation of joint cost to Polyester and Nylon

	Polyester	Nylon
Output in units (a)	12,500 units	10,000 units
Sales price per unit (b)	Rs. 100	Rs. 60
Sales value (a x b)	Rs. 12,50,000	Rs. 6,00,000
Total value (12,50,000 + 6,00,000) = 18,50,000		
Joint cost of Rs. 5,76,000 allocated in the ratio of 12,50,000 : 6,00,000	Rs. 3,89,189	Rs. 1,86,811
Cost per unit [c/a]	Rs. 31.14	Rs. 18.68

Question 9: A private limited company manufacturing fancy terry towels had valued its closing inventory of inventories of finished goods at the realisable value, inclusive of profit and the export cash incentives. Firm contracts had been received and goods were packed for export, but the ownership in these goods had not been transferred to the foreign buyers.
Comment on the valuation of the inventories by the company. (RTP Jan 26)

Answer:

Accounting Standard 2 "Valuation of Inventories" states that inventories should be valued at lower of historical cost and net realizable value. AS 9 on "Revenue Recognition" states, "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 forward contract or a government guarantee or when market exists and there is a negligible risk of failure to sell, the goods invoiced are often valued at net realisable value."

Terry Towels do not fall in the category of agricultural crops or mineral ores. Accordingly, taking into account the facts stated, the closing inventory of finished goods (Fancy terry towel) should have been valued at lower of cost and net realisable value and not at net realisable value.

Further, export incentives are recorded only in the year the export sale takes place. Therefore, the policy adopted by the company for valuing its closing inventory of inventories of finished goods is not correct.

Question 10: .
From the following information provided by LMN Ltd. for the year 2024, you are required to compute the closing inventory:
Raw Material A
Closing balance: 700 units

	Rs. per unit
Cost price including GST	280
ITC available	25
Freight inward	35
Handling charges	20
Replacement cost	200

Finished Goods B
Closing balance: 1,800 units

	Rs. per unit
Material consumed	280
Direct labour	80
Direct overhead	40

Total fixed overhead for the year was Rs. 3,60,000 on a normal capacity of 36,000 units, while actual production has been 30,000 units.
Calculate the value of closing stock when:
(i) Net Realisable Value of Finished Goods B is 500 per unit
(ii) Net Realisable Value of Finished Goods B is 380 per unit (RTP May 25)

Answer:

(i) When Net Realisable Value of Finished Goods B is Rs.500 per unit
Value of Closing Stock:

Valuation Base	Method	Qty.	Rate (Rs.)	Amount (Rs.)
Raw Material A	Cost	700	310	2,17,000
Finished Goods B	Cost	1,800	410	7,38,000
Total Value of Closing Stock				9,55,000

(ii) When Net Realisable Value of Finished Goods B is Rs. 380 per unit

Since NRV of finished goods B is less than its cost (Rs. 410, as per W.N.), raw material A is to be valued at replacement cost, and finished goods B is to be valued at NRV.

Value of Closing Stock:

Valuation Base	Basis	Qty.	Rate (Rs.)	Amount (Rs.)
Raw Material A	Replacement Cost	700	200	1,40,000
Finished Goods B	Net Realisable Value	1,800	380	6,84,000
Total Value of Closing Stock				**8,24,000**

Working Note:

Statement Showing Calculation of Cost of Raw Material A and Finished Goods B

Raw Material A

	Amount (Rs.)
Cost Price (280 - 25)	255
Add: Freight Inward	35
Add: Handling Charges	20
Total Cost	**310**

Finished Goods B

	Amount (Rs.)
Materials Consumed	280
Direct Labour	80
Variable Overheads	40
Fixed Overheads (Rs.3,60,000 / 36,000 units)	10
Total Cost	**410**

Question 11:

Well Wear Limited is a Textile Manufacturing Company and engaged in the production of Polyester (P) and Nylon (N). While manufacturing the main products, a by-product Fiber (F) is also produced. Details of the cost of production are as under:

Purchase of Raw Material for manufacturing process of

30,000 units	**Rs. 3,50,000**
Wages paid	**Rs. 1,60,000**
Fixed overheads	**Rs. 1,20,000**
Variable overheads	**Rs. 60,000**
Output:	
Polyester (P)	**12,500 Units**
Nylon (N)	**10,000 Units**
Fiber (F)	**3,200 Units**
Closing Inventory:	
Polyester (P)	**1,600 Units**
Nylon(N)	**400 Units**

Average market price of Polyester and Nylon is Rs. 100 and Rs. 60 per unit respectively, by-product Fiber is sold@Rs. 40 per unit. There is a profit of Rs. 8,000 on sale of by-product after incurring separate processing expenses of Rs. 10,000 and packing charges of Rs. 9,000. Rs. 5,000 was realized from sale of scrap.

On the basis of the above information, you are required to compute the value of closing inventory of Polyester and Nylon. (PYP May 24 7M)

Answer:

As per 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.

Determination of value of closing inventory of Polyester and Nylon

	Polyester	Nylon
Closing inventory in units	1,600 units	400 units
Cost per unit	Rs. 31.14	Rs. 18.68
Value of closing inventory	Rs. 49,824	Rs. 7,472

Working Notes

2. Calculation of net realizable value of by-product, Fiber

		Rs.
Selling price of by-product Fiber	(3,200 units x Rs. 40 per unit)	1,28,000
Less: Separate processing charges of by-product Fiber		(10,000)
Packing charges		(9,000)
Net realizable value of by-product Fiber		1,09,000

2. Calculation of cost of conversion for allocation between joint products Polyester and Nylon

	Rs.	Rs.
Raw material		3,50,000
Wages		1,60,000
Fixed overhead		1,20,000
Variable overhead		60,000
		6,90,000
Less: NRV of by-product Fiber (W.N. 1)	(1,09,000)	
Sale value of scrap	(5,000)	(1,14,000)
Joint cost to be allocated between Polyester and Nylon		5,76,000

Determination of "basis for allocation" and allocation of joint cost to Polyester and Nylon

	Polyester	Nylon
Output in units (a)	12,500 units	10,000 units
Sales price per unit (b)	Rs. 100	Rs. 60
Sales value (a x b)	Rs. 12,50,000	Rs. 6,00,000
Total value (12,50,000 + 6,00,000) = 18,50,000		
Joint cost of Rs. 5,76,000 allocated in the ratio of 12,50,000 : 6,00,000	Rs. 3,89,189	Rs. 1,86,811
Cost per unit [c/a]	Rs. 31.14	Rs. 18.68

Question 12:

SR Limited is a manufacturing company and engaged in the production of Finished goods 'MP' for which Raw material 'RP' is required.

The company provides following information for the year ended March 31st 2025:

Particulars		Units	₹
Opening Inventory	MP	4,000	1,20,000
	RP	4,400	52,800
Purchase of RP		40,000	4,80,000
Labour		3,23,200	
Overheads (Fixed)		3,15,000	
Sales		40,200	11,20,000
Closing Inventory	MP	4,200	
RP		4,000	

The expected production for the year was 45,000 units of the MP. Due to fall in market demand, the sales price for the MP was ₹ 22 per unit and the replacement cost for the RP was ₹11.50 per unit on the closing day.

You are required to calculate the value of Closing Stock of 'MP' and 'RP' as on 31st March 2025. (PYP Sept 25 5M)

Answer:

Calculation of cost for closing inventory

Particulars	Unit (₹)	Total (₹)
Cost of Material Consumed (40,400 x 12)	12	4,84,800
Direct Labour	8	3,23,200
Fixed Overhead 3,15,000 x 40,400 / 45,000	7	2,82,800
Cost of Production	27	10,90,800
Cost of closing inventory per unit (10,90,800/ 40,400)		₹ 27
Net Realisable Value per unit		₹ 22

Since net realisable value is less than cost, closing inventory will be valued at ₹ 22.

As NRV of the MP (finished goods) is less than its cost, relevant raw materials will be valued at replacement cost i.e. ₹11.50.

Therefore, value of closing inventory: MP (finished goods) (4,200 x 22) ₹ 92,400

Raw Materials RP (4,000 x 11.50) ₹ **46,000**

Working Notes:

1. Units produced (actual) Production = Sales + Closing FG – Opening FG
   = 40,200 + 4,200 – 4,000 = 40,400 units.
2. Raw material (RP) movement (units)
   Total RP available = Opening RP + Purchases = 4,400 + 40,000 = 44,400 units.
   RP consumed = 44,400 – Closing RP (4,000) = 40,400 units.
   (Thus 1 unit RP is used per 1 unit MP.)
3. Cost per unit of RP (weighted average)
   Total cost of RP = Opening value ₹ 52,800 + Purchases ₹ 4,80,000 = ₹ 5,32,800.
   Cost per unit RP = 5,32,800 ÷ 44,400 = ₹ 12.00 per unit.

AS – 4: Contingencies and Events Occurring after the Balance Sheet Date

Illustrations

Illustration 1

In X Co. Ltd., theft of cash of Rs.5 lakhs by the cashier in January, 20X1 was detected only in May, 20X1. The accounts of the company were not yet approved by the Board of Directors of the company.

Decide whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.20X1.

Solution:

As per AS 4 (Revised) 'Contingencies and Events occurring after the Balance Sheet Date', an event occurring after the balance sheet date may require adjustment to the reported amounts of assets, liabilities, expenses or incomes.

If a fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognise the loss amounting Rs.5,00,000 and adjust the accounts of the company for the year ended 31st March, 20X1.

Illustration 2

An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.20X2. The accounting year of the company ended on 31.3.20X2. The accounts were approved on 30.6.20X2. The loss from earthquake is estimated at Rs.30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

Solution:

AS 4 (Revised) "Contingencies and Events Occurring after the Balance Sheet Date", states that 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. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.20X2. Therefore, loss occurred due to earthquake is not to be recognised in the financial year 20 X1- 20X2.

However, according to the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the earthquake has caused major destruction; therefore, fundamental accounting assumption of going concern would have to be evaluated. Considering that the going concern assumption is still valid, the fact of earthquake together with an estimated loss of Rs.30 lakhs should be disclosed in the report of the approving authority for financial year 20X1-X2 to enable users of financial statements to make proper evaluations and decisions.

Illustration 3

A company has filed a legal suit against the debtor from whom Rs.15 lakh is recoverable as on 31.3.20X1. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 20X1. Can the company provide for full amount of Rs.15 lakhs as provision for doubtful debts? Discuss.

Solution:

As per AS 4 (Revised) "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 the estimation of amounts relating to conditions existing at the balance sheet date. In the given case, company should make the provision for doubtful debts, as legal suit has been filed on 31st March, 20X1 and the chances of recovery from the suit are not good. Though, the actual result of legal suit will be known in future yet situation of non-recovery from the debtors exists before finalisation of financial statements. Therefore, provision for doubtful debts should be made for the year ended on 31st March, 20X1.

Illustration 4

In preparing the financial statements of R Ltd. for the year ended 31st March, 20X1, 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, 20X1 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Solution:

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, 20X1. The 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 Rs.100 lakhs in April, 20X1 for 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 5

A Limited Company closed its accounting year on 30.6.20X1 and the accounts for that period were considered and approved by the board of directors on 20th August, 20X1. The company was engaged in laying pipeline for an oil company deep beneath the earth. While doing the boring work on 1.9.20X1 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of Rs.80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.20X1.

Solution:

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 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 it is not an 'event occurring after the balance sheet date'.

Illustration 6

While preparing its final accounts for the year ended 31st March, 20X1 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 20X1 a trade receivable for Rs.2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 20X1 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, 20X1?

Solution:

As per Accounting Standard 4, 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 Rs.2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31 st March, 20X1. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 20X1, then this would have been treated as non-adjusting event and only disclosure required as per AS 4 (Revised), would have been sufficient.

Illustration 7

Y Ltd. has book debts and has a doubt over recoverability of some of the book debts. The amount that cannot be recovered is not quantifiable. Thus, Y Ltd. is of the opinion that provision for doubtful debts should not be created. Y Ltd. creates provision for certain other expenses on estimated basis.

Whether contention of Y Ltd. is correct?

Solution:

As per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date" if it is likely that a contingency will result in a loss to an entity then it should create provision for that contingency on the estimated basis.

Based on the above, the contention that provision for doubtful debt is not be created merely because the amount is not quantifiable is not correct. Hence Y Ltd. should make provision in the books on the basis of estimation.

Test Your Knowledge

1. **Cash amounting to Rs.4 lakhs, stolen by the cashier in the month of March 20X1, was detected in April, 20X1. The financial statements for the year ended 31st March, 20X1 were approved by the Board of Directors on 15th May, 20X1. As per Accounting Standards, this is _ for the financial statements year ended on 31st March, 20X1.**
   (a) An Adjusting event.
   (b) Non-adjusting event.
   (c) Contingency.
   (d) Provision

2. **As per Accounting Standards, events occurring after the balance sheet date are_____**
   (a) Only favourable events that occur between the balance sheet date and the date when the financial statements are approved by the Board of directors.
   (b) Only unfavourable events that occur between the balance sheet date and the date when the financial statements are approved by the Board of directors.
   (c) 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.
   (d) Those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are not approved by the Board of directors.

3. **AS 4 does not apply to_____**
   (a) Obligation under retirement benefit plans.
   (b) Commitments arising from long term lease contracts.
   (c) liabilities of life assurance and general insurance enterprises arising from policies issued
   (d) All of the above.

4. **A Ltd. sold its building for Rs.50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is Rs.30 lakhs. As on 31st March, 20X1, the documentation and legal formalities are pending. For the financial year ended 31st March, 20X1**
   (a) The company should record the sale.
   (b) The company should recognise the profit of Rs.20 lakhs in its profit and loss account.
   (c) Both (a) and (b).
   (d) The company should disclose the profit of Rs.20 lakhs in notes to accounts.

Answer to the Multiple Choice Questions

1.	(a)	2.	(c)	3.	(d)	4.	(c)

Scenario Based Questions

5. **A Ltd. has sold its building for Rs.50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is Rs.30 lakhs. As on 31st March, 20X1, 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?**

Answer:

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 recognise the gain of Rs.20 lakhs in its profit and loss account. The building should be derecognized in the financial statements.

6. **During the year 20X1-20X2, Raj Ltd. was sued by a competitor for Rs.15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of Rs.10 lakhs in its financial statements for the year ended 31st March, 20X2. On 18th May, 20X2, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of Rs.14 lakhs. The financial statements were prepared by the company's management on 30th April, 20X2, and approved by the board on 30th May, 20X2.**

Answer:

As per AS 4 (Revised), 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.

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 20X1-X2 for which the provision was also made by it, the decision of the Court on 18th May, 20X2, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by Rs.4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Had the judgment of the Court been delivered on 1st June, 20X2, it would be considered as an event occurring after the approval of the financial statements which is not covered by AS 4 (Revised). In that case, no adjustment in the financial statements of 20X1-X2 would have been required.

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: Tee Ltd. closes its books of accounts every year on 31st March. The financial statements for the year ended 31 March 2020 are to be approved by the approving authority on 30 June 2020. During the first quarter of 2020-2021, the following events / transactions has taken place. The accountant of the company seeks your guidance for the following:

(i) Tee Ltd. has an inventory of 50 stitching machines costing at Rs. 5,500 per machine as on 31 March 2020. On 31 March 2020 the company is expecting a heavy decline in the demand in next year. The inventories are valued at cost or net realizable value, whichever is lower. During the month of April 2020, due to fall in demand, the prices have gone down drastically. The company has sold 5 machines during this month at a price of Rs. 4,000 per machine.

(ii) A fire has broken out in the company's go down on 15 April 2020. The company has estimated a loss of Rs. 25 lakhs of which 75% is recoverable from the Insurance company.

(iii) The company has entered into a sale agreement on 30 March 2020 to sell a property for a consideration of Rs. 7,50,000 which is being carried in the books at Rs. 5,50,000 at the year end. The transfer of risk and reward and sale is complete in the month of May 2020 when conveyance and possession get completed.

(iv) The company has received, during the year 2018-2019, a government grant of Rs. 15 lakhs for purchase of a machine. The company has received a notice for refund of the said grant on 15 June, 2020 due to violation of some of the conditions of grant during the year 2019-2020. You are required to state with reasons, how the above transactions will be dealt with in the financial statement for the year ended 31st March 2020.

(MTP Oct '23, RTP May'22, RTP May '25)

Answer:

Events occurring after the balance sheet date are those significant events, both favourable and unfavorable, 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. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern is not appropriate. In the given case, financial statements are approved by the approving authority on 30 June 2020. On the basis of above principles, following will be the accounting treatment in the financial statements for the year ended at 31 March 2020:

(i) Since on 31 March 2020, Tee Ltd. was expecting a heavy decline in the demand of the stitching machine. Therefore, decline in the value during April, 2020 will be considered as an adjusting event. Hence, Tee Ltd. needs to adjust the amounts recognized in its financial statements w.r.t. net realizable value at the end of the reporting period. Accordingly, inventory should be written down to Rs. 4,000 per machine. Total value of inventory in the books will be 50 machines x Rs. 4,000 = Rs. 2,00,000.

(ii) A fire took place after the balance sheet date i.e. during 2020 -2021 financial year. Hence, corresponding financials of 2019-2020 financial year should not be adjusted for loss occurred due to fire. However, in this circumstance, the going concern assumption will be evaluated. In case the going concern assumption is considered to be appropriate even after the occurrence of fire, no disclosure of the same is required in the financial statements. Otherwise, disclosure be given.

(iii) Since the transfer of risk and reward and sale was complete in the month of May, 2020 when conveyance and possession got complete, no revenue should be recognized with respect to it in the

financial statements of 2019-2020. However, a disclosure for the same should be given by the entity.

(iv) Since the notice has been received after 31 March but before 30 June 2020 (approval date), the said grant shall be adjusted in the financial statements for financial year 2019 -2020 because the violation of the conditions took place in the financial year 2019 -2020 and the company must be aware of it.

Question 2: State with reasons, how the following events would be dealt with in the financial statements of Hari Ltd. for the year ended 31st March, 2022 (accounts were approved on 25th July, 2022):

(1) Negotiations with another company for acquisition of its business was started on 21st January, 2022. Hari Ltd. invested ₹ 40 lakh on 22nd April, 2022.

(2) The company made a provision for bad debts @ 4% of its total debtors (as per trend followed from the previous years). In the second week of March 2022, a debtor for ₹ 2,50,000 had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In May, 2022 the debtor became bankrupt.

(3) During the year 2021-22, Hari Ltd. was sued by a competitor for ₹ 13 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Hari Ltd. provided for a sum of ₹ 8 lakhs in its financial statements for the year ended 31st March, 2022. On 26th May, 2022, the Court decided in favour of the party alleging infringement of the trademark and ordered Hari Ltd. to pay the aggrieved party a sum of ₹ 12 lakhs.

(4) Cashier of Hari Ltd. embezzled cash amounting to ₹ 3,00,000 during March, 2022. However the same comes to the notice of Company management during August, 2022.

(5) Cheques dated 31st March, 2022 collected in the month of April, 2022. All cheques are presented to the bank in the month of April, 2022 and are also realized in the same month in the normal course after deposit in the bank. (MTP Sep'22, MTP Jan 25 S2 7M)

Answer:

1. As per AS 4'Contingencies and Events Occurring After the Balance Sheet Date', 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 ₹ 40 lakhs in April, 2022 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.
2. As per AS 4, adjustment 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. A debtor for ₹ 2,50,000 suffered heavy loss due to earthquake in the second week of March, 2022 which was not covered by insurance. This information with its implications was already known to the company. The fact that he became bankrupt in May, 2022 (after the balance sheet date) is only an additional information related to the existing condition on the balance sheet date. Accordingly, full provision for bad debts amounting ₹ 2,50,000 should be made, to cover the loss arising due to the insolvency of a debtor, in the final accounts for the year ended 31st March 2022.
3. As per AS 4, 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. In the given case, since Hari Ltd. was sued by a competitor for infringement of a trademark during the year 2021- 22 for which

the provision was also made by it, the decision of the Court on 26 th May, 2022, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Hari Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

4. As the embezzlement of cash comes to the notice of company management only after approval of financial statements by board of directors of the company, then the treatment will be done as per the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" and the same will not be adjusted in the financial statements for the year ended 31st March, 2022. This being an extra-ordinary item should be disclosed in the statement of profit and loss as a part of loss for the year ending March, 2023, in a manner, that its impact on current profit or loss can be perceived.
5. Collection of cheques after balance sheet date is not an adjusting event even if the cheques bear the date of 31st March. Recognition of cheques in hand is therefore not consistent with requirements of AS 4. Moreover, the collection of cheques after balance sheet date does not represent any material change or commitments affecting financial position of the enterprise and no disclosure of such collections in the Directors' Report is necessary.

Question 3: XYZ Ltd. operates its business into various segments. Its financial year ended on 31st March, 2020 and the financial statements were approved by their approving authority on 15th June, 2020. The following material events took place:

a. **A major property was sold (it was included in the balance sheet at Rs. 25,00,000) for which contracts had been exchanged on 15th March, 2020. The sale was completed on 15th May, 2020 at a price of Rs. 26,50,000.**
b. **On 2nd April, 2020, a fire completely destroyed a manufacturing plant of the entity. It was expected that the loss of Rs. 10 million would be fully covered by the insurance company.**
c. **A claim for damage amounting to Rs. 8 million for breach of patent had been received by the entity prior to the year-end. It is the director's opinion, backed by legal advice that the claim will ultimately prove to be baseless. But it is still estimated that it would involve a considerable expenditure on legal fees.**

You are required to state with reasons, how each of the above items should be dealt with in the financial statements of XYZ Ltd. for the year ended 31st March, 2020. (PYP Nov'22)

Answer:

Treatment as per AS 4 'Contingencies and Events Occurring After the Balance Sheet Date'

(a)	The sale of property should be treated as an adjusting event since contracts had been exchanged prior to the year-end. The effect of the sale should be reflected in the financial statements ended on 31.3.2020 and the profit on sale of property Rs. 1,50,000 would be considered.
(b)	The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, it is necessary to consider the validity of the going concern assumption having regard to the extent of insurance cover. Also, since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of a note to the financial statements.
(c)	On the basis of evidence provided, the claim against the company will not succeed. Thus, Rs. 8 million should not be provided in the account, but should be disclosed by means of a contingent liability with full details of the facts. Provision should be made for legal fee expected to be incurred to the extent that they are not expected to be recovered.

Question 4: The financial statements of PQ Ltd. for the year 2024-25 approved by the Board of Directors on 15th July, 2025. The following information was provided:

(i) A suit against the company's advertisement was filed by a party on 20th April, 2025, claiming damages of Rs. 25 lakhs.

(ii) The terms and conditions for acquisition of business of another company have been decided by March, 2025. But the financial resources were arranged in April, 2025 and amount invested was Rs. 50 lakhs.

(iii) Theft of cash of Rs. 5 lakhs by the cashier on 31st March, 2025 but was detected on 16th July, 2025.

(iv) Company sent a proposal to sell an immovable property for Rs. 40 lakhs in March, 2025. The book value of the property was Rs. 30 lakhs on 31st March, 2025. However, the deed was registered on 15th April, 2025.

(v) A, major fire has damaged the assets in a factory on 5th April, 2025. However, the assets are fully insured.

With reference to AS-4 "Contingencies and events occurring after the balance sheet date", state whether the above mentioned events will be treated as contingencies, adjusting events or non-adjusting events occurring after the balance sheet date.

(MTP May 25 S1 7M, MTP Sep 24 S1 7M, MTP Sep 25 S1 7M)

Answer:

(i) Suit filed against the company is a contingent liability but it was not existing as on balance sheet date as the suit was filed on 20th April after the balance Sheet date. As per AS 4, 'Contingencies' used in the Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur. Hence, it will have no effect on financial statements and will be a non-adjusting event.

(ii) In the given case, terms and conditions for acquisition of business were finalised and carried out before the closure of the books of accounts but transaction for payment of financial resources was effected in April, 2024. This is clearly an event occuring after the balance sheet date. Hence, necessary adjustment to assets and liabilities for acquisition of business is necessary in the financial statements for the year ended 31st March 2024.

(iii) Only those significant events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustment to assets and liabilities existing on the balance sheet date or may require disclosure. In the given case, theft of cash was detected on 16th July, 2024 after approval of financial statements by the Board of Directors, hence no treatment is required.

(iv) 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. In the given case, sale of immovable property was under proposal stage (negotiations also not started) on the balance sheet date. Therefore, no adjustment to assets for sale of immovable property is required in the financial statements for the year ended 31st March, 2024.

(v) The condition of fire occurrence was not existing on the balance sheet date. Only the disclosure regarding event of fire and loss being completely insured may be given in the report of approving authority.

AS – 5: Net Profit or Loss for the period, Prior period items and Changes in Accounting Policies

Illustrations

Illustration

From the past 5 financial years, an old outstanding balance of Rs.50,000 was still appearing as sundry creditor in the current year balance sheet of People Ltd. The company is certain that this amount is not payable due to one or more reasons. Therefore, it decided to write off the said amount in its current year's books of accounts and recognize it as income. The company treated the amount of Rs.50,000 written off as a prior period item and made the adjustments accordingly.

The company is of the view that since sundry balances were recognized in the prior period(s), its related written-off amount should be treated as a prior period item.

Solution:

No, the company is not correct in treating the amount written off as a prior period item. As per AS 5, prior period items are income or expenses which arise in a current year due to errors or omissions in the preparation of the financial statements of one or more prior period(s).

Writing off an old outstanding balance in the current year which is appearing in its books of accounts from the past 5 financial years does not mean that there has been an error or omission in the preparation of financial statements of prior period(s). It is just a practice adopted by the company to write off the old outstanding balances of more than 5 years in its current year books of accounts. Therefore, the amount written off is not treated as a prior period item.

Hence, adjusting the amount Rs.50,000 written off as a prior period item on the basis that sundry balances were recognized in prior period(s) is not in line with AS 5.

Illustration 1

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of Rs.5.30 lakhs for the period October, 20X1 to September, 20X7 has been received and paid in February, 20X8. However, the same was accounted in the year 20X8-X9. Comment on the accounting treatment done in the said case.

Solution:

The final bill having been paid in February, 20X8 should have been accounted for in the annual accounts of the company for the year ended 31st March, 20X8. 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 20X8, this material charge has arisen in the current period i.e., year ended 31st March, 20X9. Therefore, it should be treated as 'Prior period item' as per AS 5. As per AS 5, 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 AS 5. 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

(i) During the year 20X1-20X2, a medium size manufacturing company wrote down its inventories to net realisable value by Rs.5,00,000. Is a separate disclosure necessary?

(ii) A company signed an agreement with the Employees Union on 1.9.20X2 for revision of wages with retrospective effect from 30.9.20X1. This would cost the company an additional liability of Rs.5,00,000 per annum. Is a disclosure necessary for the amount paid in 20X2-X3?

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. AS 5 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 require separate disclosure of items of income and expense in accordance with AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

(ii) It is given that revision of wages took place on 1st September, 20X2 with retrospective effect from 30.9.20X1. Therefore wages payable for the half year from 1.10.20X2 to 31.3.20X3 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 Rs.7,50,000 (for $1\frac{1}{2}$ years @ Rs.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. Such an expense does not qualify as an extraordinary item. However, as per AS 5, 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 3

The company finds that the inventory sheets of 31.3.20X1 did not include two pages containing details of inventory worth Rs.14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 20X2.

Solution:

AS 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 AS 5. Separate disclosure of this item as a prior period item is required as per AS 5.

Illustration 4

Explain whether the following will constitute a change in accounting policy or not as per AS 5.

(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

(ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organisation. Such employees will get pension of Rs.20,000 per month.

Earlier there was no such scheme of pension in the organisation.

Solution:

As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

(i) Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.

(ii) Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy.

Illustration 5

In the current year, A Ltd. changed the depreciation method from the Straight Line Method (SLM) to Written Down Value (WDV) method. When A Ltd. recomputed depreciation retrospectively as per the new method, deficiency arose in depreciation in respect of past years. Therefore, it reduced the carrying amount of the asset by the amount of deficiency and such change in carrying amount (deficiency amount) has been debited to the statement of profit and loss as an extraordinary expense.

Whether the change in the carrying amount of assets due to the change in depreciation method should be treated as an extraordinary item?

Solution:

As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" extraordinary items are 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.

A change in the method of charging depreciation is not an event that is clearly distinct from the ordinary activities of the entity. In the instant case, A Ltd. has changed the depreciation method and treated the reduction in carrying amount (or amount of deficiency in depreciation) of the asset as an extraordinary expense. This is not correct. Such deficiency should be treated as a normal expense.

A change in the estimated useful life of a depreciable asset (i.e. change in depreciation method) affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

The change in depreciation method is considered as a change in accounting estimate as per the provisions of AS 5.

Test Your Knowledge

1. **A change in the estimated life of the asset, which necessitates adjustment in the depreciation is an example of**
   - **(a)** Prior period item.
   - **(b)** Ordinary item.
   - **(c)** Extraordinary item.
   - **(d)** Change in accounting estimate.

2. **Which of the following is considered as an extraordinary item as per AS 5?**
   - **(a)** Write down or write-off of receivables, inventory and intangible assets.
   - **(b)** Gains and losses from sale or abandonment of equipment used in a business.
   - **(c)** Effects of a strike, including those against competitors and major suppliers.
   - **(d)** Flood damage from unusually heavy rain or a normally dry environment.

3. **Which one of the following is an example of extraordinary item?**
   - **(a)** The write down of inventories to their net realisable value
   - **(b)** Reversal of write down of inventories
   - **(c)** Government grants become refundable
   - **(d)** Reversal of provisions.

4. **Extraordinary items are income or expenses**
   - **(a)** That arise from events clearly distinct from the ordinary activities of the enterprise.
   - **(b)** That are not expected to recur frequently or regularly.
   - **(c)** Both (a) and (b).
   - **(d)** None of the three.

5. **An audit stock verification during the year ended 31st March, 20X1 revealed that opening stock of the year was understated by Rs.5 lakhs due to wrong counting. While finalizing accounts, your opinion will be**
   - **(a)** It is not a prior period item and no separate disclosure is required
   - **(b)** It should be treated as a prior period adjustment and should be separately disclosed in the current year's financial statement
   - **(c)** The adjustment of Rs.5 lakhs in both opening stock of current year and profit brought forward from previous year should be made
   - **(d)** Both (b) and (c).

Answer to the Multiple-Choice Questions

1.	(d)	2.	(d)	3.	(c)	4.	(c)	5.	(d)

Scenario Based Questions

6. A company (Z Ltd.) is engaged in the business of providing consultancy services. A few days back, it received a notice from GST department raising a demand of GST on consultancy services provided by it for Rs.500,000. Recently Z Ltd. paid the demand. In the books, the payment is recorded as an extraordinary expenditure.
Whether payment of tax demand raised by the taxation authority can be recognised as an extraordinary item?

Answer:

No, payment of tax cannot be recognised as an extraordinary item.

As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" an extraordinary item is income or expenses that arise from events or transactions that are clearly distinct from ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

In the given case, providing consultancy service is an ordinary activity of Z Ltd. Thus, GST paid pursuant to the demand raised by GST department is also a part of an ordinary activity of Z Ltd. Recognising such payments as an extra-ordinary item is contrary to AS 5.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: A company created a provision of Rs. 7,50,000 for staff welfare while preparing the financial statements for the year 2020-21. On 31st March 2021, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welfare to Rs. 10,00,000. The accounts were approved by Board of Directors on 15th April, 2021. You are required to explain the treatment of such revision in financial statements for the year ended 31st March 2021 in line with the provisions of AS 5? (MTP April '22)

Answer:

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the change in amount of staff welfare provision amounting Rs. 2,50,000 is neither a prior period item nor an extraordinary item. It is a change in estimate, which has been occurred in the year 2020-21. As per the provisions of the standard, normally, all items of income and expense which are recognized in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates. However, the effect of such change in accounting estimate should be classified using the same classification in the statement of profit and loss, as was used previously, for the estimate.

Question 2: The Accountant of a company has sought your opinion with relevant reasons, whether the following will be treated as change in Accounting Policy or not for the year ended 31st March, 2020. Please advise him in the following situations in accordance with the provisions of relevant Accounting Standard;

(i) Provision for doubtful debts was created @ 2% till 31st March, 2019. From the Financial year 2019 - 2020, the rate of provision has been changed to 3%.

(ii) During the year ended 31st March, 2020, the management has introduced a formal gratuity scheme in place of ad-hoc ex-gratia payments to employees on retirement.

(iii) Till the previous year the furniture was depreciated on straight line basis over a period of 5 years. From current year, the useful life of furniture has been changed to 3 years.

(iv) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees will get pension of Rs. 20,000 per month. Earlier there was no such scheme of pension in the organization.

(v) During the year ended 31st March, 2020, there was change in cost formula in measuring the cost of inventories. (RTP May 22,PYP Nov'22, RTP May '25)

Answer:

(i) In the given case, company has created 2% provision for doubtful debts till 31st March, 2019. Subsequently in 2019-20, the company revised the estimates based on the changed circumstances and wants to create 3% provision. Thus change in rate of provision of doubtful debt is change in estimate and is not change in accounting policy. This change will affect only current year.

(ii) As per AS 5, the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is a transaction which is substantially different from the previous policy, will not be treated as change in an accounting policy.

(iii) Change in useful life of furniture from 5 years to 3 years is a change in estimate and is not a change in accounting policy.

(iv) Adoption of a new accounting policy for events or transactions which did not occur previously should

not be treated as a change in an accounting policy. Hence the introduction of new pension scheme is not a change in accounting policy.

(v) Change in cost formula used in measurement of cost of inventories is a change in accounting policy.

Question 3:

The management of Pluto Limited has sought your opinion with relevant reasons, whether the following transactions will be treated as changes in Accounting Policy or not for the year ended 31st March, 2021. Please advise them in the following situations in accordance with the provisions of Accounting Standard 5:

(i) **During the year ended 31st March, 2021, the management has introduced a formal retirement gratuity scheme in place of ad-hoc ex-gratia payments to its employees on retirement.**

(ii) **Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees would receive a pension of ₹ 25,000 per month. Earlier there was no such scheme of pension in the organization.**

(iii) **Provision for doubtful Trade Receivables was created @2.5% till 31 st March, 2020. From 1st April,2020, the rate of provision has been changed to 5%**

(iv) **For the year ended 31st March,2021 there was change in the cost formula in measuring the cost of Inventories.**

(v) **Till the end of the previous year, Computers were depreciated on Straight Line Basis over a period of 5 years. From current year, the useful life of Computers has been changed to 3 years. (MTP Oct'22)**

Answer:

(i) As per AS 5, the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is a transaction which is substantially different from the previous transaction, will not be treated as change in an accounting policy.

(ii) Adoption of a new accounting policy for events or transactions which did not occur previously should not be treated as a change in an accounting policy. Hence the introduction of new pension scheme is not a change in accounting policy.

(iii) In the given case, company has created 2.5 % provision for doubtful debts till 31st March, 2020. Subsequently from 1st April, 2020, the company revised the estimates based on the changed circumstances and wants to create 5% provision. Thus change in rate of provision of doubtful debt is change in estimate and is not change in accounting policy. This change will affect only current year.

(iv) Change in cost formula used in measurement of cost of inventories is a change in accounting policy.

(v) Change in useful life of computers from 5 years to 3 years is a change in estimate and is not a change in accounting policy.

Question 4:

Bela Ltd. has a vacant land measuring 20,000 sq. mts, which it had no intention to use in the future. The Company decided to sell the land to tide over its liquidity problems and made a profit of Rs.10 Lakhs by selling the said land. Moreover, there was a fire in the factory and a part of the unused factory shed valued at Rs. 8 Lakhs was destroyed. The loss from fire was set off against the profit from sale of land and profit of Rs. 2 lakhs was disclosed as net profit

from sale of assets.
You are required to examine the treatment and disclosure done by the company and advise the company in line with AS 5. (RTP Nov 22)

Answer:

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" 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. In the given case the selling of land to tide over liquidation problems as well as fire in the Factory does not constitute ordinary activities of the Company. These items are distinct from the ordinary activities of the business. Both the events are material in nature and expected not to recur frequently or regularly. Thus, these are Extraordinary Items.

Therefore, in the given case, disclosing net profits by setting off fire losses against profit from sale of land is not correct. The profit on sale of land, and loss due to fire should be disclosed separately in the statement of profit and loss .

Question 5:
State whether the following items are examples of change in Accounting Policy / Change in Accounting Estimates / Extraordinary items / Prior period items / Ordinary Activity:
(i) Actual bad debts turning out to be more than provisions.
(ii) Change from Cost model to Revaluation model for measurement of carrying amount of PPE.
(iii) Government grant receivable as compensation for expenses incurred in previous accounting period.
(iv) Treating operating lease as finance lease.
(v) Capitalization of borrowing cost on working capital.
(vi) Legislative changes having long term retrospective application.
(vii) Change in the method of depreciation from straight line to WDV.
(viii) Government grant becoming refundable.
(ix) Applying 10% depreciation instead of 15% on furniture.
(x) Change in useful life of fixed assets. (RTP May '23)

Answer:

Classification of given items is as follows:

Sr.No.	Particulars	Remarks
(i)	Actual bad debts turning out to be more than provisions	Change in Accounting Estimates
(ii)	Change from Cost model to Revaluation model for measurement of carrying amount of PPE	Change in Accounting Policy
(iii)	Government grant receivable as compensation for expenses incurred in previous accounting period	Extra -ordinary Items
(iv)	Treating operating lease as finance lease.	Prior- period Items
(v)	Capitalization of borrowing cost on working capital	Prior-period Items (as interest on working capital loans is not eligible for capitalization)

(vi)	Legislative changes having long term retrospective application	Ordinary Activity
(vii)	Change in the method of depreciation from straight line to WDV	Change in Accounting Estimates
(viii)	Government grant becoming refundable	Extra -ordinary Items
(ix)	Applying 10% depreciation instead of 15% on furniture	Prior- period Items
(x)	Change in useful life of fixed assets	Change in Accounting Estimates

Question 6: TQ Cycles Ltd. is in the manufacturing of bicycles, a labour intensive manufacturing sector. In April 2022, the Government enhanced the minimum wages payable to workers with retrospective effect from the 1st January,2022. Due to this legislative change, the additional wages for the period from January 2022 to March 2022 amounted to ₹ 30 lakhs. The management asked the Finance manager to charge ₹ 30 lakhs as prior period item while finalizing financial statements for the year 2022-23. Further, the Finance manager is of the view that this amount being abnormal should be disclosed as extra-ordinary item in the Profit and loss account for the financial year 2021-22.
Discuss with reference to applicable Accounting Standards. (PYP May'22)

Answer:

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances which though related to prior periods, are determined in the current period.

It is given that revision of wages took place in April, 2022 with retrospective effect from 1st January, 2022. Therefore, wages payable for the period from 1 01.2022 to 31.3.2022 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. The full amount of wages payable to workers will be treated as an expense of current year and it will be charged to profit & loss account for the year 2022-23 as normal expenses.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Such an expense does not qualify as an extraordinary item. Therefore, finance manager is incorrect in treating increase as extraordinary item. However, as per AS 5, 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.

Therefore, additional wages liability of ₹ 30 lakhs should be disclosed separately in the financial statements of TQ Cycles Ltd. for the year ended 31st March, 2023.

Question 7: During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company's accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write it back to the Profit and Loss account as a prior period item.
Is the company's proposed accounting treatment correct? Discuss. (RTP Jan 25)

Answer:

The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation

of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", refer only to 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. The balance amount left in the provision created earlier is not as a result of error in the past. So it will not be considered as prior period item. Such write back of provision is not an ordinary feature of the business, it shall be considered as an extra-ordinary item.

As per paragraph 8 of AS 5, 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. Hence, the amount so written-back (if material) should be disclosed as an extraordinary item as per AS 5 rather than as prior period items.

Question 8:
(a) When can an item qualify to be a prior period item as per AS 5?
(b) The company finds that the stock sheets of 31.3.2024 did not include two pages containing details of inventory worth ₹ 20 lakhs. State, how will you deal with this matter in the accounts of A Ltd., for the year ended 31st March, 2025 with reference to AS 5. (RTP Sept 25)

Answer:

(a) According to para 16 of AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', prior period items refers to those income or expenses, which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period e.g., arrears payable to workers in current period as a result of revision of wages with retrospective effect.

(b) As per para 16 of AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', omission of two pages containing details of inventory worth ₹20 lakhs in 31.3.2024 is a prior period item. As per para 19 of the standard, prior period items are normally included in the determination of net profit or loss for the current period. Accordingly, ₹20 lakhs must be added to opening stock of 1.4.2024. 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.

Question 9: Best Ltd. is engaged in the business of providing consultancy services. A few days back, it received a notice from GST department raising a demand of GST on consultancy services provided by it for ₹ 2,50,000.
Recently Best Ltd. paid the demand. In the books, the payment is recorded as an extraordinary expenditure.
Whether payment of tax demand raised by the taxation authority can be recognised as an extraordinary item? (RTP Jan 26)

Answer:

No, payment of tax cannot be recognised as an extraordinary item.

As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", extraordinary items are income or expenses that arise from events or transactions which are clearly

distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

In the instant case, providing consultancy services is the ordinary business activity of Best Ltd. The GST liability arises from these ordinary transactions. Payment of GST pursuant to a demand by the taxation authority is part of the normal business operations of the company.

Therefore, recording the payment of GST as an extraordinary expenditure is not correct. Such payments are ordinary expenses and should be recognised as part of the profit or loss from ordinary activities, and cannot be treated as an extraordinary item. Recognising such payments as an extra-ordinary item is contrary to AS 5.

Question 10:

Sneha an employee of Omre Limited went on maternity leave with pay for 9 months on 1st January 2024 up to 30th September 2024. Her monthly pay was ₹ 1,50,000. While preparing the financial statements for the year ended 31st March 2024, the salary of Sneha for 3 months (1 January 2024 to 31st March 2024) was not provided due to omission. When Sneha joined on 1st October 2024 the whole salary for 9 months (1st January 2024 to 30th September 2024) was paid to her.

With reference to AS-5 'Net Profit or Loss for the period, Prior Period Items and Change in Accounting Policies' you are required to determine if this is an example of prior period item and are also required to pass journal entry for the F.Y. 2024-2025.

Answer:

As per AS- 5 "Net Profit or Loss for the Period", Prior Period Items and Changes in Accounting Policies, the term 'prior period items', refers to 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. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss so that their impact on the current profit or loss can be perceived.

Hence, in this case salary paid to Sneha for 3 months i.e. 1.1.2024 to 31.3.2024 ₹4,50,000 (1,50,000 x 3) will be classified as prior period item in FY 2024 -25 and following journal entry shall be passed:

(i) Journal entry in FY 2024-25

Salary A/c (₹ 1,50,000 x 6)	Dr.	9,00,000	
Prior period item (₹ 1,50,000 x 3)	Dr.	4,50,000	
To Bank A/c			13,50,000

(Being salary related to 9 months paid out of which 3 month's salary is prior period item)

Alternative Entry

Prior Period Item (₹ 1,50,000 x 3)	Dr.	4,50,000	
To Bank A/c			4,50,000

(Being Salary related to 3 month's salary is prior period item)

Salary A/c (₹1,50,000 x 6)	Dr.	9,00,000	
To Bank A/c			9,00,000

(Being salary related to 6 month's salary)

(ii) AS 5 inter alia states that the term 'prior period items' does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period. Accordingly, in the second case though Sneha was terminated on 1.1.2024 i.e. in 2023- 2024, yet she was reinstated due to court's order in 2024 -2025, with the instruction by the court to pay the salary for the intervening period i.e. with retrospective effect from January, 2024.

The adjustment of salary of ₹ 4,50,000 (for January 2024 to March, 2024) would not be considered as prior period item and will be accounted for in the books as current year expense. Thus, the entire amount of Salary of ₹ 13,50,000 for January, 2024 to September, 2024 is a current year expense only.

Salary A/c (1,50,000 x 9)	Dr.	13,50,000	
To Bank A/c			13,50,000

(Being 9 month's salary paid during the year)

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AS – 7: Construction Contracts

Illustrations

Illustration 1

XYZ construction Ltd, a construction company undertakes the construction of an industrial complex. It has separate proposals raised for each unit to be constructed in the industrial complex. Since each unit is subject to separate negotiation, he is able to identify the costs and revenues attributable to each unit. Should XYZ Ltd, treat construction of each unit as a separate construction contract according to AS 7?

Solution:

As per AS 7 '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 identified.

Therefore, XYZ Ltd. is required to treat construction of each unit as a separate construction contract.

Illustration 2

AB contactors enters into a contract on 1st January 20X1 with XY to construct a 5- storied building. Under the contract, AB is required to complete the construction in 3 years (i.e., by 31st December 20X3). The following information is relevant:

Fixed price (agreed) ₹5 crore

Material cost escalation (to the extent of 20% of increase in material cost)

Labour cost escalation (up to 30% of increase in minimum wages)

In case AB is able to complete the construction in less than 2 years and 10 months, it will be entitled for an additional incentive of ₹50 lakh. However, in case the construction is delayed beyond 3 years and 2 months, XY will charge a penalty of ₹20 lakh. At the start of the contract, AB has a reason to believe that construction will be completed in 2 years and 8 months. Assume that the construction was actually completed in 2 years 9 months.

Labour cost was originally estimated to be ₹1.20 crore (based on initial minimum wages). However, the costs have increased by 25% during the construction period.

Material costs have increased by 40% due to short-supply. The total increase in material cost due to the 40% escalation is ₹80 lakh.

You are required to suggest what should be the contract revenue in above case?

Assume that in year 20X2, XY has requested AB to increase the scope of the contract. An additional floor is required to be constructed and there is an increase in contract fee by ₹1 crore.

AB has incurred a cost of ₹20 lakh for getting the local authority approvals which it will be entitled to claim from XY in addition to the increase in the fixed fee.

Also measure the total contract revenue in this case.

Solution:

Total Revenue after considering the escalation costs, claims and incentives:

	Rs.
Fixed Price:	5.00 crore
Incentive for early completion	0.50 crore
Material costs recovery (to the extent of 20%)	0.40 crore
Labour costs recovery (Actual increase is less than 30%)	0.30 crore
[1.20 crore x 25%]	
Total Contract Revenue	6.20 crore
Add: Variation to the contract	1.00 crore
Add: Claims recoverable from XY	0.20 crore
Total Contract Revenue	7.40 crore

Illustration 3 (Percentage completion method)

X Ltd. commenced a construction contract on 01-04-20X1. The fixed contract price agreed was ₹2,00,000. The company incurred ₹81,000 in 20X1-X2 for 45% work and received ₹79,000 as progress payment from the customer. The cost incurred in 20X2-X3 was ₹89,000 to complete the rest of work. Show the extract of the Profit and Loss Account and Customer's Account for the related years.

Solution:

Profit & Loss Account

Year		Rs. 000	Year		Rs. 000
20X1-X2	To Construction Costs (for 45% work)	81	20X1-X2	By Contract Price (45% of Contract Price)	90
	To Net profit (for 45% work)	9			
		90			90
20X2-X3	ToConstruction costs (for 55% work)	89	20X2-X3	By Contract Price (55% of Contract Price)	110
	To Net Profit (for 55% work)	21			
		110			110

Customer's Account

Year		Rs. 000	Year		Rs. 000
20X1-X2	ToContract Price	90	20X1-X2	By Bank	79
				By Balance c/d	11
		90			90
20X2-X3	To Balance b/d	11	20X2-X3		
	ToContract Price	110		By Bank	121
		121			121

AS 7 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

(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 in accordance with paragraph 35.

Illustration 4

PQ & Associates undertakes a construction contract the details of which are provided below:

Total Contract Value	**₹40 lakh**
Costs incurred to date	**₹3 lakh**
Estimated future costs of completion	**₹30 lakh**
Work completed	**10%**

The work has started some time ago and there is an uncertainty with respect to the outcome of the contract due to expected changes in regulations. PQ is certain that it would be able to recover the costs incurred to date.

Solution:

In the given case, revenue and costs can only be recognised to the extent of the costs incurred and those which are expected to be recovered. Therefore, the profit & loss statement would appear as under:

Contract Revenue	₹3 lakh
Contract Costs	₹3 lakh
Contract Profit	Nil

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method.

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Illustration 5 (Stage of completion for a loss-making contract)

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data for Year 1.

Information for Year 1	**Rs. 000**
Contract price (Fixed)	**600**
Cost incurred to date	**390**
Estimated cost to complete	**260**

Assume that the contract period is 2 years. The contract is 100% completed by Year 2. Actual costs incurred is the same as total estimated costs to complete (Cost incurred to date plus estimated cost to complete).

Solution:

		Amount INR Rs. 000	
	Year (1)	**Total up to Year2 (2)**	**Year 2 (2) – (1)**
A. Cost incurred to date	(390)	(650)	(260)
B. Estimate of cost to completion	(260)	-	-
C. Estimated total cost	(650)	650	650
D. Degree of completion (A/C)	60%	100%	40%
E. Revenue Recognised (60% of 600) (100% of 600)	360	600	240
Total foreseeable loss (650 – 600)	50		

Less: Loss for current year (E – A)	(30)		
Expected loss to be recognised immediately	(20)		
Reversal of Loss provision in Year 2			20

Profit & Loss A/c (Year 1)

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

Profit & Loss A/c (Year 2)

	Rs.		Rs.
To Construction costs	260	By Contract Price	240
		By Reversal of Provision for loss	20
	260		260

Illustration 6

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, 20X1.

	(Rs. in lakhs)
Total Contract Price	**1,000**
Work Certified for the cost incurred	**500**
Work yet not Certified for the cost incurred	**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 issued by your institute.

Solution:

(a)		(Rs. in lakhs)
	Amount of foreseeable loss:	
	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 AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

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

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

(c) Proportion of total contract value recognized as revenue: 55% of Rs. 1,000 lakhs = Rs. 550 lakhs

(d) Gross Amount due from/to customers = (Contract costs + Recognized profits – Recognized Losses) – (Progress payments received + Progress payments to be

received)

= (605 + Nil – 100) – (400 + 140)

Rs. in lakhs

= [505 – 540] Rs. in lakhs

Amount due to customers = Rs. 35 lakhs

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

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

	Rs. in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognised losses	(100)
Progress billings Rs. (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35
Method of revenue recognition (use of percentage completion method)	
Method of determining state of completion (based on proportionate cost	

Illustration 7

On 1st December, 20X1, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for Rs. 85 lakhs. On 31st March, 20X2, the company found that it had already spent Rs.64,99,000 on the construction. Prudent estimate of additional cost for completion was Rs.32,01,000. What amount should be recognized in the statement of profit and loss for the year ended 31st March, 20X2 as per provisions of Accounting Standard 7 (Revised)?

Solution:

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	Rs.
Cost incurred till 31st March, 20X2	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 AS 7, the amount of Rs. 12,00,000 is required to be recognised as an expense.

Contract work in progress = Rs. 64, 99, 000 ×100 / 97, 00, 000 = 67%

Proportion of total contract value recognised as turnover:

= 67% of Rs. 85,00,000 = Rs. 56,95,000.

The amount of expected loss will be split as under:

Particulars	Workings	Amount
Expected Loss	97,00,000- 85,00,000	12,00,000
Contract revenue	67% of 85,00,000	56,95,000
Contract cost	Given	64,99,000
Actual loss	56,95,000- 64,99,000	8,04,000
Amount of provision required [As per Para 35]	12,00,000- 8,04,000	3,96,000

Test Your Knowledge

The below information relates to Questions 1 – 3:

XY Ltd. agrees to construct a building on behalf of its client GH Ltd. on 1st April 20X1. The expected completion time is 3 years. XY Ltd. incurred a cost of Rs. 30 lakh up to 31st March 20X2. It is expected that additional costs of Rs. 90 lakh. Total contract value is Rs. 112 lakh. As at 31st March 20X2, XY Ltd. has billed GH Ltd. for Rs. 42 lakh as per the agreement. Assume that the work is completed to the extent of 75% by the end of Year 2.

1. **Revenue to be recognized by XY Ltd. for the year ended 31st March 20X2 is**
   - **(a)** Rs. 28 lakh
   - **(b)** Rs. 42 lakh
   - **(c)** Rs. 30 lakh
   - **(d)** Rs. 32 lakh

2. **Total expense to be recognised in Year 1 is**
   - **(a)** Rs. 30 lakh
   - **(b)** Rs. 120 lakh
   - **(c)** Rs. 38 lakh
   - **(d)** Rs. 36 lakh

3. **Revenue to be recognised for year 2 is**
   - **(a)** Rs. 84 lakh
   - **(b)** Rs. 42 lakh
   - **(c)** Rs. 56 lakh
   - **(d)** Rs. 28 lakh

Below information relates to Questions 4 – 5

M/s AV has presented the information for Contract No. XY123:

Total contract value	Rs. 370 lakh
Certified work completed	Rs. 320 lakh
Costs incurred to date	Rs. 360 lakh
Progress Payments received	Rs. 300 lakh

Expected future costs to be incurred Rs. 50 lakh. The revenue to be recognised based on the certified work completed.

4. **Revenue to be recognised by M/s AV is**
   - **(a)** Rs. 320 lakh
   - **(b)** Rs. 370 lakh
   - **(c)** Rs. 360 lakh
   - **(d)** Rs. 400 lakh

5. **Total expense to be recognised by M/s AV is**
   - **(a)** Rs. 380 lakh
   - **(b)** Rs. 400 lakh
   - **(c)** Rs. 320 lakh
   - **(d)** Rs. 360 lakh

6. **LP Contractors undertakes a fixed price contract of Rs. 200 lakh. Transactions related to the contract include:**
   Material purchased: Rs. 80 lakh Unused material: Rs. 30 lakh Labour charges: Rs. 60 lakh Machine used for 3 years for the contract. Original cost of the machine is Rs. 100 lakh.

Expected useful life is 15 years.

Estimated future costs to be incurred to complete the contract: Rs. 80 lakh. Loss on contract to be recognised is:

(a) Rs. 40 lakh

(b) Rs. 10 lakh

(c) Rs. 90 lakh

(d) Rs. 50 lakh

Answer to the Multiple Choice Questions

1.	(a)	2.	(c)	3.	(c)	4.	(a)	5.	(d)	6.	(b)

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Theoretical Questions

7. It is argued that profit on construction contracts should not be recognised until the contract is completed. Please explain whether you believe that this suggestion would improve the quality of financial reporting for long term construction contracts.

Answer:

Usually, construction contracts are long term nature i.e., the contracts are entered in one accounting period, however, the work performed will flow into more than one accounting year. If the profit on construction contracts is not recognised over the construction period, then the costs incurred during the earlier years of the contract would be recognised without any corresponding revenue. This will result in losses for initial years followed high profits in future years.

The current treatment under AS 7 results in matching of revenue and associated costs as they are recognised during the same period. Also, the current accounting incorporates the prudence concept as any foreseeable losses are accounted for immediately.

Therefore, AS 7 results in a fair representation of the underlying financial substance of the transaction.

8. A contractor has entered into a contract with a municipal body for construction of a flyover. As per the contract terms, the contractor will receive an additional Rs. 2 Crore as incentive if the construction of the flyover were to be finished within a period of two years from the start of the contract. The contractor wants to recognize this revenue since in the past he has been able to meet similar targets very easily.
Explain whether the contractor's view-point is correct?

Answer:

The contractor's view is not entirely correct in considering the variation as a variation as a part of contract revenue. There is an argument that he has been able to complete similar contracts within stipulated time. However, each contract needs to be assessed in isolation with respect to the specific challenges associated with the timing and uncertainty in completion.

Accordingly, the contractor needs to validate the assumptions with respect to the specific contract. Only after that assessment is done, the incentive of Rs. 2 crore may be included within the contract revenue.

Scenario Based Questions

9. A construction contractor has a fixed price contract for Rs. 9,000 lakhs to build a bridge in 3 years time frame. A summary of some of the financial data is as under:

	(Amount Rs. in lakhs)		
	Year 1	Year 2	Year 3
Initial Amount for revenue agreed in contract	9,000	9,000	9,000
Variation in Revenue (+)	-	200	200
Contracts costs incurred up to the reporting date	2,093	6,168*	8,100**
Estimated profit for whole contract	950	1,000	1,000

***Includes Rs. 100 lakhs for standard materials stored at the site to be used in year 3 to complete the work.**

****Excludes Rs. 100 lakhs for standard material brought forward from year 2. The variation in cost and revenue in year 2 has been approved by customer.**

Compute year wise amount of revenue, expenses, contract cost to complete and profit or loss to be recognized in the Statement of Profit and Loss as per AS-7 (revised).

(PYP May 24)

Answer:

The amounts of revenue, expenses and profit recognized in the statement of profit and loss in three years are computed below:

(Amount in Rs. lakhs)

	Up to the reporting date	Recognized in previous years	Recognized in current year
Year 1			
Revenue (9,000 x 26%)	2,340	-	2,340
Expenses (8,050 x 26%)	2,093	-	2,093
Profit	247	-	247
Year 2			
Revenue (9,200 x 74%)	6,808	2,340	4,468
Expenses (8,200 x 74%)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200 x 100%)	9,200	6,808	2,392
Expenses (8,200 x 100%)	8,200	6,068	2,132
Profit	1,000	740	260

Working Note:

	Year 1	Year 2	Year 3
Revenue after considering variations	9,000	9,200	9,200
Less: Estimated profit for whole contract	950	1,000	1,000
Estimated total cost of the contract (A)	8,050	8,200	8,200
Actual cost incurred upto the reporting date (B)	2,093	6,068	8,200
		(6,168-100)	(8,100+100)
Degree of completion (B/A)	26%	74%	100%

10. Akar Ltd. Signed on 01/04/X1, a construction contract for Rs. 1,50,00,000. Following particulars are extracted in respect of contract, for the year ended 31/03/X2.

- **Materials used Rs. 71,00,000**
- **Labour charges paid Rs. 36,00,000**
- **Hire charges of plant Rs. 10,00,000**
- **Other contract cost incurred Rs. 15,00,000**
- **Labour charges of Rs. 2,00,000 are still outstanding on 31.3.X2.**
- **It is estimated that by spending further Rs. 33,50,000 the work can be completed in all respect.**

You are required to compute profit/loss for the year to be taken to Profit & Loss Account and any provision for foreseeable loss to be recognized as per AS 7.

Answer:

Statement showing the amount of profit/loss to be taken to Profit and Loss Account and additional provision for the foreseeable loss as per AS 7

	Cost of Construction	**Rs.**	**Rs.**
	Material used		71,00,000
	Labour Charges paid	36,00,000	
Add:	Outstanding on 31.03.20X2		38,00,000
		2,00,000	
	Hire Charges of Plant		10,00,000
	Other Contract cost incurred		15,00,000
	Cost incurred upto 31.03.20X2		1,34,00,000
Add:	Estimated future cost		33,50,000
	Total Estimated cost of construction		1,67,50,000
	Degree of completion (1,34,00,000/1,67,50,000 x 100)		80%
	Revenue recognized (80% of 1,50,00,000)		1,20,00,000
	Total foreseeable loss (1,67,50,000 - 1,50,00,000)		17,50,000
Less:	Loss for the current year (1,34,00,000 - 1,20,00,000)		14,00,000
	Loss to be provided for		3,50,000

11. RT Enterprises has entered into a fixed price contract for construction of a tower with its customer. Initial tender price agreed is Rs. 220 crore. At the start of the contract, it is estimated that total costs to be incurred will be Rs. 200 crore. At the end of year 1, this estimate stands revised to Rs. 202 crore. Assume that the construction is expected to be completed in 3 years.

During year 2, the customer has requested for a variation in the contract. As a result of that, the total contract value will increase by Rs. 5 crore and the costs will increase by Rs. 3 crore.

RT has decided to measure the stage of completion on the basis of the proportion of contract costs incurred to the total estimated contract costs. Contract costs incurred at the end of each year is:

Year 1: Rs. 52.52 crore

Year 2: Rs. 154.20 crore (including unused material of 2.5 crore) Year 3: Rs. 205 crore.

You are required to calculate:

(a) Stage of completion for each year.

(b) Profit to be recognised for each year.

Answer:

(a) Stage of completion = Costs incurred to date / Total estimated costs Year 1: 52.52 crore / 202 crore = 26%

Year 2: (154.20 crore – 2.50 crore) / 205 crore = 74%

Year 3: 205 crore / 205 crore = 100%

(b) Profit for the year

	Year 1	Year 2	Year 3
Contract Revenue (1)	57.20 crore	109.30 crore	58.50 crore
	(220 crore x 26%)	(225 crore x 74% -57.20 crore)	(225 crore x 100% - 109.30 crore -57.20 crore)
Contract Cost (2)	52.52 crore	99.18 crore	53.30 crore
	(202 crore x 26%)	(205 crore x 74% -52.52 crore)	(205 crore x 100% -99.18 crore – 52.52 crore)
Contract Profit (1) –(2)	4.68 crore	10.12 crore	5.20 crore

12. On 1st December, 20X1, GR Construction Co. Ltd. undertook a contract to construct a building for Rs. 45 lakhs. On 31st March, 20X2, the company found that it had already spent Rs. 32.50 lakhs on the construction. Additional cost of completion is estimated at Rs. 15.10 lakhs. What amount should be charged to revenue in the final accounts for the year ended 31st March, 20X2 as per provisions of AS-7? (RTP May 25)

Answer:

	Rs. in lakhs
Cost of construction incurred till date	32.50
Add: Estimated future cost	15.10
Total estimated cost of construction	47.60

Percentage of completion till date to total estimated cost of construction

= (32.50/47.60) x 100 = 68.28%

Proportion of total contract value recognised as revenue for the year ended 31st March, 20X2 per AS 7 (Revised)

= Contract price x percentage of completion

= Rs. 45 lakh x 68.28% = Rs. 30.73 lakhs.

	(Rs. in lakhs)
Total cost of construction	**47.60**
Less: Total contract price	**(45.00)**
Total foreseeable loss to be recognized as expense	**2.60**

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

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: The following data is provided for M/s. Raj Construction Co.

(i) Contract Price - ₹ 85 lakhs

(ii) Materials issued - ₹ 21 Lakhs out of which Materials costing ₹ 4 Lakhs is still lying unused.at the end of the period.

(iii) Labour Expenses for workers engaged at site - ₹ 16 Lakhs (out of which ₹ 1 Lakh is still unpaid)

(iv) Specific Contract Costs = ₹ 5 Lakhs

(v) Sub-Contract Costs for work executed - ₹ 7 Lakhs, Advances paid to Suh-Contractors - ₹ 4 Lakhs

(vi) Further Cost estimated to be incurred to complete the contract - ₹ 35 Lakhs

You are required to compute the Percentage of Completion, the Contract Revenue and Cost to be recognized as per AS-7. (MTP Oct'22)

Answer:

Computation of contract cost

	₹ Lakh	₹ Lakh
Material cost incurred on the contract (net of closing stock)	21-4	17
Add: Labour cost incurred on the contract (including outstanding amount)		16
Specified contract cost	given	5
Sub-contract cost (advances should not be considered)		7
Cost incurred (till date)		45
Add: further cost to be incurred		35
Total contract cost		80

Percentage of completion = Cost incurred till date/Estimated total cost
= ₹ 45,00,000/₹ 80,00,000 = 56.25%

Contract revenue and costs to be recognized

Contract revenue (₹ 85,00,000x56.25%) = ₹ 47,81,250 Contract costs = ₹ 45,00,000

Question 2:

(a) Sky Limited belongs to Heavy Engineering Contractors specializing in construction of Flyovers. The company just entered into a contract with a local municipal corporation for building a flyover. No activity has started on this contract.
As per the terms of the contract, Sky Limited will receive an additional Rs. 50 lakhs if the construction of the flyover were to be finished within a period of two years from the commencement of the contract. The Accountant of the entity wants to recognize this revenue since in the past the company has been able to meet similar targets very easily. Give your opinion on this treatment.

(b) ABC Ltd., a construction contractor, undertakes the construction of commercial complex for XYZ Ltd. ABC Ltd. submitted separate proposals for each of 3 units of commercial complex. A single agreement is entered into between the two parties. The agreement lays down the value of each of the 3 units i.e. Rs. 50 lakh, Rs. 60 lakh and Rs. 75 lakh respectively. Agreement also lays down the completion time for each unit.
Comment, with reference to AS 7, whether ABC Ltd., should treat it as a single contract or three separate contracts. (RTP May '23 & Nov '23)

Answer:

(a) According to AS 7 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when both the conditions are met:

(i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and

(ii) the amount of the incentive payment can be measured reliably.

In the given problem, the contract has not even begun and hence the contractor (Sky Limited) should not recognize any revenue of this contract. Therefore, the accountant's contention for recognizing Rs. 50 lakhs as revenue is not correct.

(b) As per AS 7 '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 identified.

ABC Ltd. has submitted separate proposals for each of the 3 units of commercial complex. Also the revenue and completion time has been laid down for each unit separately which implies separate negotiation for them.

Therefore, ABC Ltd. is required to treat construction of each unit as a separate construction contract as the above-mentioned conditions of AS 7 are fulfilled in the given case.

Question 3: Rajendra undertook a contract ₹ 20,00,000 on an arrangement that 80% of the value of work done, as certified by the architect of the contractee should be paid immediately and that the remaining 20% be retained until the Contract was completed. In Year 1, the amounts expended were ₹ 8,60,000, the work was certified for ₹ 8,00,000 and 80% of this was paid as agreed. It was estimated that future expenditure to complete the Contract would be ₹ 10,00,000. In Year 2, the amounts expended were ₹ 4,75,000. Three-fourth of the work under contract was certified as done by December 31st and 80% of this was received accordingly. It was estimated that future expenditure to complete the Contract would be ₹ 4,00,000. In Year 3, the amounts expended were ₹ 3,10,000 and on June 30th, the whole Contract was completed. Show how Contract revenue would be recognized in the P & L A/c of Mr. Rajendra each year. (MTP Sep '23)

Answer:

(a) Year 1	₹
Actual expenditure	8,60,000
Future estimated expenditure	10,00,000
Total Expenditure	18,60,000

% of work completed = 8,60,000 / 18,60,000 ×100 = 46.24%(Rounded off)

Revenue to be recognized (cumulative) = 20,00,000 x 76.95% = 15,39,000

Less: revenue recognized in Year 1 = (9,24,800)

Revenue to be recognized in Year 2 ₹ 6,14,200

Year 2

Actual expenditure 4,75,000

Future Expenditure 4,00,000
Expenditure incurred in year 1 8,60,000
17,35,000
% of work completed = 4,75,000+8,60,000 / 17,35,000 = 76.95%(Rounded off)
Revenue to be recognized (cumulative) = 20,00,000 ×76.95%
= 15,39,000
Less: revenue recognized in Year 1 = (9,24,800)
Revenue to be recognized in Year 1 = Rs. 6,14,200

Year 3

Whole contract got completed therefore total contract value less revenue recognized up to year 2 will be amount of revenue to be recognized in year 3 i.e. 20,00,000 – 15,39,000 (9,24,800 + 6,14,200) = ₹ 4,61,000. Note: Calendar year has been considered as accounting year.

Question 4: AP Ltd., a construction contractor, undertakes the construction of commercial complex for Kay Ltd. AP Ltd. submitted separate proposals for each of 3 units of commercial complex. A single agreement is entered into between the two parties. The agreement lays down the value of each of the 3 units, i.e. Rs. 50 Lakh Rs. 60 Lakh and Rs. 75 Lakh respectively. Agreement also lays down the completion time for each unit.
Comment, with reference to AS- 7, whether AP Ltd., should treat it as a single contract or three separate contracts. (RTP May 25)

Answer:

(i) As per AS 7 '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 identified.

Therefore, AP Ltd. is required to treat construction of each unit as a separate construction contract as the above-mentioned conditions of AS 7 are fulfilled in the given case.

(ii)

	Rs. in lakhs
Cost of construction incurred till date	32.50
Add: Estimated future cost	15.10
Total estimated cost of construction	47.60

Percentage of completion till date to total estimated cost of construction
= (32.50/47.60)×100 = 68.28%

Proportion of total contract value recognised as revenue for the year ended 31st March, 2024 per AS 7 (Revised)
= Contract price x percentage of completion
= Rs. 45 lakh x 68.28% = Rs. 30.73 lakhs.

	(Rs. in lakhs)
Total cost of construction	47.60
Less: Total contract price	(45.00)
Total foreseeable loss to be recognized as expense	2.60

According to AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

Question 5: Constructions Limited is engaged in the business of constructing Flyovers and Railway over bridges. It obtained a contract from Railway Authorities to construct a railway over bridge for ₹ 400 crores. The construction of the railway over bridge is expected to be completed in 4 years.
At the outset of the contract, it was estimated that the total costs to be incurred will be ₹ 370 crores but by the end of year 1, this estimate stands revised to ₹ 375 crores.
During year 3, the Construction Limited has requested for a variation in the contract which is approved by Railway Authorities and accordingly the total contract value will increase by ₹ 10 crores and costs will increase by ₹ 7 crores.
The Constructions Limited decided to measure the stage of completion on the basis of the proportion of contract costs incurred to the total estimated contract costs. Contract costs incurred at the end of each year is:
Year 1 ₹ 98.8 crores
Year 2 ₹ 202.4 crores
Year 3 ₹ 310 crores (including unused material of 3 crores)
Year 4 ₹ 382 crores
You are required to:
(1) Calculate stage of completion of contract for each year
(2) Profit to be recognised for each year. (MTP Sept 25 S1 7 Marks)

Answer:

(i) Stage of completion = Costs incurred to date / Total estimated costs

Year 1: 98.8 crore / 375 crore = 26.35%

Year 2: 202.4 crore / 375 crore = 53.97%

Year 3: (310 crore – 3 crore) / (375+7) crore = 80.37%

Year 4: 382 crore / 382 crore = 100%

(ii) Profit to be recognized each year has been calculated as follows:

	Year 1	Year 2	Year 3	Year 4
Contract Revenue (1)	105.40 crore	110.48 crore	113.64 crore	80.48 crore
	(400 crore x 26.35%)	(400 crore x 53.97% - 105.40 crore)	(410 crore x 80.37% - 105.40 crore - 110.48 crore)	(410 crore x 100% - 105.40 crore - 110.48 crore - 113.64 crore)
Contract Cost (2)	98.8 crore	103.60 crore	104.60 crore	75 crore
		202.40 - 98.80 crore)	(307 crore - 98.8 crore - 103.60 crore)	(382 crore - 98.8 crore- 103.6 crore – 104.6 crore)
Contract Profit (1) – (2)	6.60 crore	6.88 crore	9.04 crore	5.48 crore

Question 6: 10. A company took a construction contract for ₹ 100 lakhs in January 2024. It was found that 80% of the contract was completed at a cost of ₹ 92 lakhs on the closing date

i.e. on 31.3.2025. The company estimates further expenditure of ₹ 23 lakhs for completing the contract. The expected loss would be ₹15 lakhs. Can the company recognise the loss in the financial statements prepared for the year ended 31.3.2025? (RTP Sept 25)

Answer:

As per paragraphs 31 and 35 of AS 7 on Construction Contracts, an expected loss on the construction contract should be recognized as an expense immediately irrespective of

(i) whether or not the work has commenced on the contract; or

(ii) the stage of completion of the contract; or

(iii) the amount of profits expected to arise in other contracts.

Hence, the company must recognize the loss immediately.

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AS – 9: Revenue Recognition

Illustrations

Illustration 1

Zigato runs a food-delivery business. As per the arrangement, Zigato allows customers to order food from local restaurants and is responsible the delivery of the food within stipulated time. During a particular year, it collects the money on orders made online as under:

Total price for the food item	**-**	**Rs.200 lakhs**
Delivery charges	**-**	**Rs.60 lakhs**
GST	**-**	**Rs.40 lakhs**
Total	**-**	**Rs.300 lakhs**

Zigato has received Rs.300 lakhs for the above orders from customers and the orders were delivered to the customer in stipulated time.

How much revenue should be recognised by restaurants and how much revenue should be recognised by Zigato for the year?

Solution:

The risks and rewards associated with the food item are not with Zigato. When a customer has ordered a food item, whether the item will be prepared or not is the responsibility of the restaurant and not Zigato. Similarly, the responsibility to deliver the food item is with Zigato and the restaurant does not undertake responsibility for the same.

Therefore, the restaurant undertakes the principal's responsibility to prepare the food and ensure its quality. Zigato, on the other hand, is only responsible to deliver the food. Thus, Zigato is acting as an agent. Hence, it can only recognize revenue relating to that activity (which it does in the ordinary course of business). The revenue for Zigato, therefore, is Rs.60 lakhs, whereas, the revenue for restaurants will be Rs.200 lakhs.

It may be noted that the GST of Rs.40 lakhs is a liability payable to the Government (third party), hence it does not form part of revenue.

Illustration 2

AB sells goods to CD on 1st March 20X1. CD is having significant cash flows issues since last few months. However, it is trying to raise funding through bank loan to be able to run its operations in future. On 5th of May 20X1, CD is able to seek the funding and is expected to be able to pay for the goods in future.

At the time of sale, it is difficult for AB to ascertain whether it will be able to collect the amount from CD due to poor financial conditions.

Explain how the recognition of revenue be done by AB?

Solution:

In the above case, AB should not recognise any revenue on 1st of March and until that uncertainty of recovery is clear. Hence, the revenue can only be recognised by AB on 5th of May 20X1. The inventory transferred to CD until that date is required to be shown as its own inventory [inventory lying with customers].

Illustration 3

AB sells goods to CD on 1st January 20X1 for Rs.2 lakhs. After the sale was made, CD is having significant cash flows issues. It is trying to raise funding through bank loan to be able to run

its operations in future. However, it is unable to do so and has gone under liquidation on 15th of March 20X1.
At the time of sale, there was no reason for AB to believe that it will not be able to collect the amount from CD in future.
Explain how the recognition of revenue be done by AB for the year ended 31st March 20X1?

Solution:

In the above case, at the time of sale, it was not unreasonable for AB to expect ultimate collection from CD. Therefore, AB should recognise the revenue of Rs.2 lakhs on 1st of January 20X1 and recognise a receivable for the same amount.

Later, since CD went into liquidation, AB should write off the receivables and book a loss in his books.

Accounting in the books of AB 1st January 20X1

CD A/c (Receivables) To Revenue A/c (Being goods sold to CD Ltd)	Dr.	Rs.2 lakhs	 Rs.2 lakhs

15th March 20X1

Bad Debts A/c To CD A/c (Receivables)A/c (Being receivables from CD written off due to its liquidation)	Dr.	Rs.2 lakhs	 Rs.2 lakhs

Illustration 4
During the year ended 31st March 20X1, ZX Enterprises has recognized Rs.100 lakhs on accrual basis income from dividend on units of mutual funds held by it. The dividends on mutual funds were declared on 15th June, 20X1. The dividend was proposed on 10th April, 20X1.
Whether the above treatment is as per the relevant Accounting Standard?

Solution:

Dividends from investments in shares are not recognized in the statement of profit and loss until a right to receive payment is established. In the given situation, the dividend is proposed on 10th April, 20X1, while it is declared on 15th June, 20X1. Thus, the right to receive the payment of dividend gets established on 15th June, 20X1.

The recognition of Rs.100 lakhs on accrual basis in the financial year 20X0-20X1 is not correct as per AS 9 'Revenue Recognition'.

Illustration 5
Y Ltd., used certain resources of X Ltd. In return X Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Ltd. during the year 20 X1-X2. You are required to state whether and on what basis these revenues can be recognized by X Ltd.

Solution:

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

(i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable. Therefore X Ltd. should recognize interest revenue of ₹ 10 Lakhs

(ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement. X Ltd. therefore should recognize royalty revenue of ₹ 15 Lakhs.

Illustration 6

The Board of Directors decided on 31.3.20X2 to increase the sale price of certain items retrospectively from 1st January, 20X2. In view of this price revision with effect from 1st January 20X2, the company has to receive Rs.15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2.

Accountant cannot make up his mind whether to include Rs.15 lakhs in the sales for 20X1-20X2.Advise.

Solution:

Price revision was effected during the current accounting period 20 X1-20X2. As a result, the company stands to receive Rs.15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2. If the company is able to assess the ultimate collection with reasonable certainty, only then additional revenue arising out of the said price revision may be recognized in 20X1-20X2.

If the company is not reasonably certain on ultimate collection Rs.15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2, it shall postpone recognition of revenue and disclose it in financial statements for year 20X1-20X2 as per AS 1

Illustration 7

A claim lodged with the Railways in March, 20X1 for loss of goods of Rs.2,00,000 had been passed for payment in March, 20X3 for Rs.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, 20X3.

Solution:

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. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is certain to be collected. 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 Rs.1,50,000 were collected against a claim of Rs.2,00,000. So this transaction can not be taken as a Prior Period Item.

Hence receipt of Rs.1,50,000 shall be recognized as revenue in year ended 31st March, 20X3

In the light of AS 5, it will not be treated as extraordinary item. However, AS 5 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.

Test Your Knowledge

1. **Which of the conditions mentioned below must be met to recognize revenue from the sale of goods?**
   (i) the entity selling does not retain any continuing influence or control over the goods;
   (ii) when the goods are dispatched to the buyer;
   (iii) revenue can be measured reliably;
   (iv) the supplier is paid for the goods;
   (v) it is reasonably certain that the buyer will pay for the goods;
   (vi) the buyer has paid for the goods.
   (a) (i), (ii) and (v)
   (b) (ii), (iii) and (iv)
   (c) (i), (iii) and (v)
   (d) (i), (iv) and (v)

2. **Consignment inventory is an arrangement whereby inventory is held by one party but owned by another party. Which of the following indicates that the inventory in question is a consignment inventory?**
   (a) Manufacturer cannot require the dealer to return the inventory
   (b) Dealer has the right to return the inventory
   (c) Manufacture is responsible for the pricing of goods and any changes in the pricing can only be approved by the manufacturer.
   (d) Manufacture is responsible for the holding the goods and any changes in the pricing can only be approved by the dealer

3. **Which of the following transactions qualify as revenue for M/s AB Enterprises?**
   (a) Sales of Rs.20 lakhs made under consignment sales.
   (b) Sale of an old machine amounting Rs.5 lakhs
   (c) Services provided to the customer in the normal course of business. Sales recorded is Rs.50,000.
   (d) Sales of Rs.25 lakhs made under consignment sales

4. **The Accounting Club has 100 members who are required to pay an annual membership fee of Rs.5,000 each. During the current year, all members have paid the fee. However, 5 members have paid an amount of Rs.10,000 each. Of these, 3 members paid the current year's fee and also the previous year's dues. Remaining 2 members have paid next years' fee of Rs.5,000 in advance.**
   Revenue from membership fee for the current year to be recognised will be:
   (a) Rs.5,25,000
   (b) Rs.5,10,000
   (c) Rs.5,00,000
   (d) Rs.5,15,000

5. **FlixNet International offers a subscription fee model to allow the paid subscribers an annual viewing of movies, sports events and other content. It allows users to register for free and have access to limited content for one month without any charges. The customer has a right to cancel the subscription within a month's time but is required to pay for 1 year subscription fee after the free period.**
   XY has subscribed for free viewing on 1st March 20X1. After 1 month, he has agreed to pay the annual membership and has paid Rs.1,200 on 31st March 20X1 for the subscription

that is valid up to 31st of March 20X2.

Revenue that can be recognized by FlixNet for the year ended 31st March 20X2 is

(a) Rs.100

(b) Rs.1,200

(c) Nil

(d) Rs.1,100

Answer to the Multiple Choice Questions

1.	(a)	2.	(c)	3.	(c)	4.	(c)	5.	(b)

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Scenario Based Questions

6. GH manufactures and sells televisions. The televisions are shipped to the customer by sea. In order to transfer risk related to the shipment of the televisions, GH also gets an insurance coverage for the goods while they are in transit from the factory to customer's location. The insurance policy will reimburse GH for the value of the goods in the event of loss or damage arising anytime up to these goods reaching customer's location. The legal title passes when the goods arrive at the customer's premises one month later.
When should Entity GH recognize revenue in its books?

Answer:

GH should recognize revenue for the sale when the goods arrive at the customer's premises. GH has not transferred the televisions' significant risks and rewards of ownership to the customer when the goods depart from the factory. This is evidenced by the fact that any insurance proceeds received from the goods' damage or destruction will be repaid to GH. Further, the legal title does not pass until the goods arrive at the customer's premises.

7. The following information of Meghna Ltd. is provided:

(i) Goods of Rs.60,000 were sold on 20-3-20X2 but at the request of the buyer these were delivered on 10-4-20X2.

(ii) On 15-1-20X2 goods of Rs.1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31-3-20X2.

(iii) Rs.1,20,000 worth of goods were sold on approval basis on 1 -12-20X1. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-1-20X2 and no approval or disapproval received for the remaining goods till 31 -3- 20X2.

(iv) Apart from the above, the company has made cash sales of Rs.7,80,000 (gross). Trade discount of 5% was allowed on the cash sales.

You are required to advise the accountant of Meghna Ltd., with valid reasons, the amount to be recognized as revenue in above cases in the context of AS 9.

Answer:

As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Case (i) The sale is complete but delivery has been postponed at buyer's request. The entity should recognize the entire sale of Rs.60,000 for the year ended 31st March, 20X2.

Case (ii) 20% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for Rs.1,20,000 (80% of Rs.1,50,000). In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

Case (iii) In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

Therefore, revenue should be recognized for the Rs.90,000 upon receipt of approval on 31-02-20X1 and for the balance Rs.30,000 on 01-03- 20X1 as the time period for rejecting the goods had expired.

Case (iv) Trade discounts given should be deducted in determining revenue. Thus Rs.39,000 should be deducted from the amount of turnover of ₹ 7,80,000 for the purpose of recognition of revenue.

Thus, revenue should be Rs.7,41,000.

8. For the year ended 31st March 20X1, KY Enterprises has entered into the following transactions.

On 31 March 20X1, KY supplied two machines to its customer ST. Both machines were accepted by ST on 31 March 20X1. Machine 1 was a machine that was routinely supplied by KY to many customers and the installation process was very simple.

Machine 1 was installed on 2 April 20X1 by ST's employees.

Machine 2 being more specialised in nature requires an installation process which is more complicated, requiring significant assistance from KY. Machine 2 was installed between 2 and 5 April 20X1. Details of costs and sales prices are as follows:

	Machine 1	Machine 2
Sale Price	3,20,000	3,00,000
Cost of production	1,60,000	1,50,000
Installation fee	nil	10,000

How should above transactions be recognized by KY Enterprises for the year ended 31st March 20X1?

Answer:

Machine 1: As the installation process is simple, revenue from Machine 1 will be recognized on 31 March 20X1.

Revenue (Machine 1)	Rs.3,20,000
Cost of Goods Sold	Rs.1,60,000
Profit during the period	Rs.1,60,000

Since the question specifies that the machine is already accepted by ST on 31 March 20X1, the revenue arising from sale of the machine needs to be recognized for the year ending 31 March 20X1. This is because acceptance of the machine indicates that the risks and rewards pursuant to the ownership are transferred to ST.

Machine 2: Installation process for Machine 2 is more complicated, requiring significant assistance from KY Ltd. However, question specifies that the machine is already accepted by ST on 31 March 20X1. Assuming that there is no further approval/acceptance required from the buyer for the Machine sold, revenue from sale of Machine 2 can be recognized for the year ending 31 March 20X1.

Revenue (Machine 2)	Rs.3,00,000
Cost of Goods Sold	Rs.1,50,000
Profit during the period	Rs.1,50,000

However, installation fee which is for rendering installation services cannot be recognized until the installation is complete. Since the machine is pending installation, the revenue in respect of installation charges Rs.10,000 needs to be recognized on 5 April 20X1 once the installation process gets completed.

9. PQR Ltd., sells agriculture products to dealers. One of the conditions of sale is that interest is 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 20X1 - X2 the company wants to recognize the entire interest receivable. Do you agree?

Answer:

As per AS 9 'Revenue Recognition', where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, 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, PQR Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstanding is also an estimate based on previous record and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: New Era Publications publishes a monthly magazine on 15th of every month. It sells advertising space in the magazine to advertisers on the terms of 80% sale value payable in advance and the balance within 30 days of the release of the publication. The sale of space for the March 2020 issue was made in February 2020. The magazine was published on its scheduled date. It received Rs. 2,40,000 on 10.3.2020 and Rs. 60,000 on 10.4.2020 for the March, 2020 issue. Discuss in the context of AS 9 the amount of revenue to be recognized and the treatment of the amount received from advertisers for the year ending 31.3.2020. What will be the treatment if the publication is delayed till 2.4.2020? (MTP Mar 22 & Oct '23)

Answer:

As per AS 9 'Revenue Recognition', in a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method as the service is performed, whichever relates the revenue to the work accomplished. In the given case, income accrues when the related advertisement appears before public. The advertisement service would be considered as performed on the day the advertisement is published and hence revenue is recognized on that date. In this case, 15.03.20 20 is the date of publication of the magazine. Hence, Rs. 3,00,000 (Rs. 2,40,000 + Rs. 60,000) is recognized as income in March, 2020. The terms of payment are not relevant for considering the date on which revenue is to be recognized. Since, the revenue of Rs. 3,00,000 will be recognized in the March, 2020, Rs. 60,000 will be treated as amount due from advertisers as on 31.03.20 20 and Rs. 2,40,000 will be treated as payment received against the sale. However, if the publication is delayed till 02.04.2020 revenue recognition will also be delayed till the advertisements get published in the magazine. In that case revenue of Rs. 3,00,000 will be recognized in the year ended 31.03.2020 after the magazine is published on 02.04.2020. The amount received from sale of advertising space on 10.03.2020 of Rs. 2,40,000 will be considered as an advance from advertisers as on 31.03.2020.

Question 2: Tonk Tanners is engaged in manufacturing of leather shoes. They provide you the following information for the year ended 31st March, 2022:

(i) On 31st December, 2021 shoes worth ₹ 3,20,000 were sent to Mohan Shoes for sale on consignment basis of which 25% shoes were unsold and lying with Mohan Shoes as on 31 st March, 2022.

(ii) On 10th January, 2022, Tonk Tanner supplied shoes worth ₹ 4,50,000 to Shani Shoes and concurrently agrees to re-purchase the same goods on 11th April. 2022.

(iii) On 21st March, 2022 shoes worth ₹ 1,60,000 were sold to Shoe Shine but due to refurbishing of their showroom being underway, on their request, shoes were delivered on 12 th April, 2022.

You are required to advise the accountant of Tonk Tanners when amount is to be recognised as revenue in 2021-2022 in above cases in the context of AS 9. (MTP March '23)

Answer:

i. **Shoes sent to Mohan Shoes (consignee) for consignment sale**

In case goods are sent for consignment sale, revenue is recognized when significant risks of ownership have passed from seller to the buyer.

In the given case, Mohan Shoes is the consignee i.e. an agent of Tonk Tanners and not the buyer. Therefore, the risk and reward is considered to vest with Tonk Tanners only till the time the sale is made to the third party by Mohan Shoes; although the goods are held by Mohan Shoes. Hence, in

the year 2021-2022, the sale will be recognized for the amount of goods sold by Mohan Shoes to the third party i.e. for ₹ 3,20,000 x 75% = ₹ 2,40,000.

ii. **Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date**

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue and should not be recognized as revenue in the year 2021 -2022. Hence, sale of ₹ 4,50,000 to Shani Shoes should not be recognized as revenue.

iii. **Delivery is delayed at buyer's request**

On 21st March, 2022, if Shoe Shine takes title and accepts billing for the goods then it is implied that the sale is complete and all the risk and rewards of ownership has been transferred to the buyer. In case no significant uncertainty exists regarding the amount of consideration for sale, revenue shall be recognized in the year 2021 -2022 irrespective of the fact that the delivery is delayed on the request of Shoe Shine.

Question 3: The following information of Meghna Ltd. is provided:

(i) Goods of Rs. 60,000 were sold on 20-3-2019 but at the request of the buyer these were delivered on 10-4-2019.

(ii) On 15-1-2019 goods of Rs. 1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31 -3-2019.

(iii) Rs. 1,20,000 worth of goods were sold on approval basis on 1 -12-2018. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-1-2019 and no approval or disapproval received for the remaining goods till 31-3-2019.

(iv) Apart from the above, the company has made cash sales of Rs. 7,80,000 (gross). Trade discount of 5% was allowed on the cash sales.

You are required to advise the accountant of Meghna Ltd., with valid reasons, the amount to be recognized as revenue in above cases in the context of AS -9. (MTP Oct'22, RTP May 25)

Answer:

As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Case (i) The sale is complete but delivery has been postponed at buyer 's request. M/s Paper Products Ltd. should recognize the entire sale of Rs.60,000 for the year ended 31st March, 2019.

Case (ii) 20% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for Rs. 1,20,000 (80% of Rs. 1,50,000). In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

Case (iii) In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting Rs. 1,20,000 as the time period for rejecting the goods had expired.

Case (iv) Trade discounts given should be deducted in determining revenue. Thus Rs. 39,000 should be deducted from the amount of turnover of Rs. 7,80,000 for the purpose of recognition of revenue. Thus, revenue should be Rs. 7,41,000.

Question 4: An infrastructure company has constructed a mall and entered into agreement with tenants towards license fee (monthly rental) and variable license fee, a percentage on the turnover of the tenant (on an annual basis). Chief Financial Officer of the company wants to account/recognize license fee as income for 12 months during current year and variable license fee as income during next year, since invoice is raised in the subsequent year. Comment whether the treatment desired by the CFO is correct or not. (RTP May 22)

Answer:

AS 9 on Revenue Recognition, is mainly concerned with the timing of recognition of revenue in the Statement of Profit and Loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. However, when uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition. Further, as per accrual concept, revenue should be recognized as and when it is accrued i.e. recorded in the financial statements of the periods to which they relate. In the present case, monthly rental towards license fee and variable license fee as a percentage on the turnover of the tenant (though on annual basis) is the income related to common financial year.

Therefore, recognizing the fee as revenue cannot be deferred simply because the invoice is raised in subsequent period. Hence it should be recognized in the financial year of accrual. Therefore, the contention of the Chief Financial Officer is not in accordance with AS 9.

Question 5: PQR Ltd., sells agriculture products to dealers. One of the conditions of sale is that interest is 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 2021-22 the company wants to recognize the entire interest receivable. Do you agree? (RTP May '23)

Answer:

As per AS 9 'Revenue Recognition', where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, 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, PQR Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstanding is also an estimate based on previous record and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

Question 6: Mithya Ltd. entered into agreement with Satya Ltd. for sale of goods costing Rs. 8 lakh at a profit of 20% on cost. The sale transaction took place on 1st February, 2024. On the same day, Satya Ltd. entered into another agreement with Mithya Ltd. to resell the same goods at Rs. 10.80 lakh on 1st August, 2024. State the treatment of this transaction in the financial statements of Mithya Ltd. as on 31.03.2024. The pre-determined re-selling price covers the holding cost of Satya Ltd. Give the Journal Entries as on 31.03.2024 in the books of Mithya Ltd. (RTP Jan 25)

Answer:

In the given case, Mithya Ltd. concurrently agreed to repurchase the same goods from Satya Ltd. on 1st February, 2024. Also the re-selling price is pre-determined and covers purchasing and holding costs of Satya Ltd. Hence, the transaction between Mithya Ltd. and Satya Ltd. on 1st February, 2024 should be accounted for as financing rather than sale. The resulting cash flow of Rs. 9.60 lakh received by Mithya Ltd., cannot be considered as revenue as per AS 9 "Revenue Recognition".

Journal Entries in the books of Mithya Ltd.

			Rs. in lakh	
1.2.2024	Bank Account	Dr.	9.60	
	To Advance from Satya Ltd*.			9.60
	(Being advance received from Satya Ltd. amounting [Rs. 8 lakh + 20% of Rs. 8 lakh = 9.60 lakh] under sale and re-purchase agreement)			
31.3.2024	Financing Charges Account	Dr.	0.40	
	To Satya Ltd.		0.40	
	(Financing charges for 2 months [(10.80 – 9.60) x 2/6]			
31.3.2024	Profit and Loss Account	Dr.	0.40	
	To Financing Charges Account		0.40	
	(Being amount of finance charges transferred to P& L Account)			

Question 7: Given the following information of Rainbow Ltd.

(i) On 15th November, goods worth Rs 5,00,000 were sold on approval basis. The period of approval was 4 months after which they were considered sold. Buyer sent approval for 75% goods sold upto 31st January and no approval or disapproval received for the remaining goods till 31st March.

(ii) On 31st March, goods worth Rs 2,40,000 were sold to Bright Ltd. but due to refurnishing of their show-room being underway, on their request, goods were delivered on 10th April.

(iii) Rainbow Ltd. supplied goods worth Rs 6,00,000 to Shyam Ltd. and concurrently agrees to re-purchase the same goods on 14th April.

(iv) Dew Ltd, used certain assets of Rainbow Ltd. Rainbow Ltd. received Rs 7.5 lakhs and Rs 12 as interest and royalties respectively from Dew Ltd. during the year 2023-24.

(v) On 25th December, goods of Rs 4,00,000 were sent on consignment basis of which 40% of the goods unsold are lying with the consignee at the year-end on 31st March.

In each of the above cases, you are required to advise, with valid reasons, the amount to be recognized as revenue under the provisions of AS-9. (MTP Jan 25 S2 4M)

Answer:

(i) As per AS 9 "Revenue Recognition", in case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting Rs 5,00,000 as the time period for rejecting the goods had expired.

(ii) The sale is complete but delivery has been postponed at buyer's request. The entity should recognize the entire sale of Rs 2,40,000 for the year ended 31st March.

(iii) Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date, such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognized as revenue. Hence no revenue to be recognized in the given case.

(iv) Revenue arising from the use by others of enterprise resources yielding interest and royalty should be recognized when no significant uncertainty as to measurability or collectability exists. The interest should be recognized on time proportion basis taking into account the amount outstanding and rate applicable. The royalty should be recognized on accrual basis in accordance with the terms of relevant agreement.

(v) 40% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for Rs 2,40,000 (60% of Rs 4,00,000). In case of consignment sale revenue should not be recognized until the goods are sold to a third party

Question 8: Indicate in each case whether revenue can be recognized and when it will be recognized as per AS-9.
(1) Trade discount and volume rebate received.
(2) Where goods are sold to distributors or others for resale.
(3) Where seller concurrently agrees to repurchase the same goods at a later date.
(4) Insurance agency commission for rendering services.
(5) On 11-03-2024 cloths worth ₹ 50,000 were sold to X mart, but due to refurbishing of their showroom being underway, on their request, clothes were delivered on 12-04-2024.
(MTP Sept 25 S1 5 Marks)

Answer:

(1) Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

(2) When goods are sold to distributor or others, revenue from such sales can generally be recognized if significant risks of ownership have passed;
however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

(3) For transactions, where seller concurrently agrees to repurchase the same goods at a later date that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognized as revenue.

(4) Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

(5) On 11.03.2024, if X mart takes title and accepts billing for the goods then it is implied that the sale is complete and all risk and reward on ownership has been transferred to the buyers.
Revenue should be recognized for year ended 31st March, 2024 notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made and items were ready for delivery to the buyer at the time.

Question 9: 11. Tonk Tanners is engaged in manufacturing of leather shoes. They provide you the following information for the year 2024-25:
(i) On 31st December, 2024 shoes worth ₹ 3,20,000 were sent to Mohan Shoes for sale on consignment basis of which 25% shoes were unsold and lying with Mohan Shoes as on 31st March, 2025.

(ii) On 10th January, 2025, Tonk Tanner supplied shoes worth ₹ 4,50,000 to Shani Shoes and concurrently agrees to re-purchase the same goods on 11th April 2025.

(iii) On 21st March, 2025 shoes worth ₹ 1,60,000 were sold to Shoe Shine but due to refurbishing of their showroom being underway, on their request, shoes were delivered on 12th April, 2025.

You are required to advise the accountant of Tonk Tanners, when amount is to be recognised as revenue in 2024 -25 in above cases in the context of AS 9. (RTP Sept 25)

Answer:

(i) Shoes sent to Mohan Shoes (consignee) for consignment sale

In case goods are sent for consignment sale, revenue is recognized when significant risks of ownership have passed from seller to the buyer.

In the given case, Mohan Shoes is the consignee i.e. an agent of Tonk Tanners and not the buyer. Therefore, the risk and reward is considered to vest with Tonk Tanners only till the time the sale is made to the third party by Mohan Shoes; although the goods are held by Mohan Shoes. Hence, in the year 2024-25, the sale will be recognized for the amount of goods sold by Mohan Shoes to the third party i.e. for ₹ 3,20,000 x 75% = ₹ 2,40,000.

(ii) Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue and should not be recognised as revenue in the year 2024-25. Hence, sale of ₹ 4,50,000 to Shani Shoes should not be recognized as revenue.

(iii) Delivery is delayed at buyer's request

On 21st March, 2025, if Shoe Shine takes title and accepts billing for the goods then it is implied that the sale is complete and all the risk and rewards of ownership has been transferred to the buyer. In case no significant uncertainty exists regarding the amount of consideration for sale, revenue shall be recognized in the year 2024-25 irrespective of the fact that the delivery is delayed on the request of Shoe Shine.

Question 10: Class Ltd. is a well-established real-estate developer and builder engaged in residential and commercial projects. In the financial year 2025, the company purchased a unit of land situated in a prime location for ₹ 225 crore, intending to develop a high-end residential complex.

Within a few months of acquisition, due to a strategic decision to reallocate resources to another project and take advantage of favorable market conditions, Class Ltd. sold the land at a price of ₹ 360 crore. The company maintained proper books of accounts, and all legal formalities for the transfer were duly completed.

Advise Class Ltd. on the recognition of revenue from this transaction in the final statement of accounts for the year ended 31st March, 2025.

Answer:

AS 9 on 'Revenue Recognition' states that revenue is recognised when it is earned and there is reasonable certainty of its collection, arising from the ordinary activities of an enterprise.

In this case, Class Ltd. is in the business of buying and selling properties. The land purchased and sold forms part of its inventory. The sale of land at ₹ 360 crore is a transaction arising from ordinary activities of the company. Therefore, the revenue is recognised when the sale is completed and collection is reasonably certain.

In the light of AS 5, this transaction will not be treated as an extraordinary item, because it arises from the ordinary course of business. However, if the amount is of such size, nature, or incidence that its disclosure is relevant to explain the performance of the enterprise, the nature and amount of such items should be disclosed separately.

Hence, ₹ 360 crore realised from the sale of land shall be recognised as revenue in the year in which the sale is completed.

Question 11:

Discuss whether the below treatment is as per relevant Accounting Standard.

(i) AB Limited purchase goods on credit from XY Limited for ₹ 150 lakhs for export. The export order of AB Limited was cancelled. AB Limited decided to sell the same goods in the local market with a price discount. XY Limited was requested to offer a price discount of 12%, which was accepted by XY Limited. The chief accountant of XY Limited wants to adjust the sales figure to the extent of the discount requested by AB Limited.

(ii) XY Limited has recognized dividend income of ₹ 10 lakhs on accrual basis on securities of face value of ₹ 100 lakhs held by it at the end of the financial year 31st March 2025. The dividend on securities was declared at the rate of 10% on 30th April 2025. The dividend was proposed on 30th March, 2025.

(iii) XY Limited sold goods of ₹ 1,50,000 on approval basis on 15th December 2024. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 60% goods upto 31st January 2025 and no approval or disapproval received for the remaining goods until 31st March, 2025. Accountant of XY Limited recognised ₹ 1,50,000 as revenue on 15th December, 2024.

(iv) In the year 2024-2025, XY Limited supplied goods of ₹ 80,000 on consignment basis to ABC (a retail outlet). ABC sold goods worth ₹ 60,000 during the year and rest of the goods are still lying in its store. XY Limited recognizes ₹ 60,000 revenue in its books for the year 2024-2025. (PYP Sept 25 4M)

Answer:

As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

(i) Trade discounts given should be deducted in determining revenue. Thus 12% should be deducted from the amount of turnover for the purpose of recognition of revenue.

The adjustment of sale figure to the extent of discount is correct as per AS 9 'Revenue Recognition'.

(ii) Dividends from investments in securities are not recognized in the statement of profit and loss until a right to receive payment is established. In the given situation, the dividend is proposed on 30th March, 2025, while it is declared on 30th April, 2025. Thus, the right to receive the payment of dividend gets established on 30th April, 2025.

The recognition of ₹ 10 lakhs on accrual basis in the end of the financial year 31st March, 2025 is not correct as per AS 9 'Revenue Recognition'.

(iii) In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.
Therefore, revenue should be recognized for the ₹ 90,000 upon receipt of approval on 31st January, 2025 and for the balance ₹ 60,000 on 15th March, 2025 as the time period for rejecting the goods had expired.

(iv) 20,000 goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for ₹ 60,000. In case of consignment sale revenue should not be recognized until the goods are sold to a third party.
The recognition of ₹ 60,000 revenues in the book for the year 2024-25 is correct as per AS 9 'Revenue Recognition'.

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AS – 10: Property, Plant and Equipment

Illustrations

Illustration 1 (Capitalising the cost of "Remodelling" a Supermarket)
Entity A, a supermarket chain, is renovating one of its major stores. The store will have more available space for in store promotion outlets after the renovation and will include a restaurant. Management is preparing the budgets for the year after the store reopens, which include the cost of remodelling and the expectation of a 15% increase in sales resulting from the store renovations, which will attract new customers. State whether the remodelling cost will be capitalised or not.

Solution:

The expenditure in remodelling the store will create future economic benefits (in the form of 15% of increase in sales) and the cost of remodelling can be measured reliably, therefore, it should be capitalised.

Illustration 2
Entity A has an existing freehold factory property, which it intends to knock down and redevelop. During the redevelopment period the company will move its production facilities to another (temporary) site. The following incremental costs will be incurred:

1. **Setup costs of Rs.5,00,000 to install machinery in the new location.**
2. **Rent of Rs.15,00,000**
3. **Removal costs of Rs.3,00,000 to transport the machinery from the old location to the temporary location.**
4. **Can these costs be capitalised into the cost of the new building?**

Solution:

Constructing or acquiring a new asset may result in incremental costs that would have been avoided if the asset had not been constructed or acquired. These costs are not to be included in the cost of the asset if they are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The costs to be incurred by the company are in the nature of costs of relocating or reorganising operations of the company and do not meet the requirement of AS 10 (Revised) and therefore, cannot be capitalised.

Illustration 3
Omega Ltd. contracted with a supplier to purchase machinery which is to be installed in its one department in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were Rs.1,40,000. These activities were supervised by a technician during the entire period, who is employed for this purpose of Rs.45,000 per month. The machine was purchased at Rs.1,58,00,000 and Rs.50,000 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of Rs.30,000 to supervise machinery installation at the factory site. You are required to ascertain the amount at which the Machinery should be capitalized.

Solution:

Particulars		Rs.
Purchase Price	Given	1,58,00,000
Add: Site Preparation Cost	Given	1,40,000
Technician's Salary	Specific/Attributable overheads for 3 months (45,000 x 3)	1,35,000
Initial Delivery Cost	Transportation	50,000
Professional Fees for Installation	Architect's Fees	30,000
Total Cost of Machinery		1,61,55,000

Illustration 4 (Capitalisation of directly attributable costs)
Entity A, which operates a major chain of supermarkets, has acquired a new store location. The new location requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the supermarket will be closed.
Management has prepared the budget for this period including expenditure related to construction and remodelling costs, salaries of staff who will be preparing the store before its opening and related utilities costs. What will be the treatment of such expenditures?

Solution:

Management should capitalise the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The supermarket cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset.

However, if the cost of salaries, utilities and storage of goods are in the nature of operating expenditure that would be incurred if the supermarket was open, then these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Illustration 5 (Operating costs incurred in the start-up period)
An amusement park has a 'soft' opening to the public, to trial run its attractions. Tickets are sold at a 50% discount during this period and the operating capacity is 80%. The official opening day of the amusement park is three months later. Management claim that the soft opening is a trial run necessary for the amusement park to be in the condition capable of operating in the intended manner. Accordingly, the net operating costs incurred should be capitalised. Comment.

Solution:

The net operating costs should not be capitalised but should be recognised in the Statement of Profit and Loss.

Even though it is running at less than full operating capacity (in this case 80% of operating capacity), there is sufficient evidence that the amusement park is capable of operating in the manner intended by management. Therefore, these costs are specific to the start-up and, therefore, should be expensed as incurred.

Illustration 6 (Consideration received comprising a combination of non- monetary and monetary assets)
Entity A exchanges land with a book value of Rs.10,00,000 for cash of Rs.20,00,000 and

plant and machinery valued at Rs.25,00,000. What will be the measurement cost of the assets received. (Consider that the transaction has commercial substance)?

Solution:

In the given case, Plant & Machinery is valued at Rs.25,00,000, which is assumed to be fair value in absence of information. Further, since fair value of land (asset given up) is not given, the transaction will be recorded at fair value of assets acquired of Rs.45,00,000 (Rs.Cash 20,00,000 + Rs.Plant & Machinery 25,00,000). Since land of book value Rs.10,00,000 is transferred in exchange of assets worth Rs.45,00,000, a gain of
Rs.35,00,000 will be recognised in the books of Entity A.

The following journal entry will be passed in the books of Entity A:

Cash/ Bank A/c	Dr.	20,00,000	
Plant & Machinery A/c	Dr.	25,00,000	
To Land			10,00,000
To Profit on Sale of Land (balancing figure)			35,00,000

Illustration 7 (Exchange of assets that lack commercial substance)
Entity A exchanges car X with a book value of Rs. 13,00,000 and a fair value of Rs.13,25,000 for cash of Rs.15,000 and car Y which has a fair value of Rs.13,10,000. The transaction lacks commercial substance as the company's cash flows are not expected to change as a result of the exchange. It is in the same position as it was before the transaction. What will be the measurement cost of the assets received?

Solution:

Since the transaction lacks commercial substance, the entity recognises the assets received at the book value of car X. Therefore, it recognises cash of Rs.15,000 and car Y as PPE with a carrying value of Rs.12,85,000.

The following journal entry will be passed in the books of Entity A:

Cash/ Bank A/c	Dr.	15,000	
Car Y A/c (balancing figure)	Dr.	12,85,000	
To Car X A/c			13,00,000

Illustration 8
What happens if the cost of the previous part/inspection was/ was not identified in the transaction in which the item was acquired or constructed?

Solution:

De-recognition of the carrying amount occurs regardless of whether the cost of the previous part/inspection was identified in the transaction in which the item was acquired or constructed.

Illustration 9
What will be your answer in the above question, if it is not practicable for an enterprise to determine the carrying amount of the replaced part/inspection?

Solution:

It may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/existing inspection component was when the item was acquired or constructed.

Illustration 10 (Revaluation on a class by class basis) Entity A is a large manufacturing group. It owns a number of industrial buildings, such as factories and warehouses and office buildings in several capital cities. The industrial buildings are located in industrial zones, whereas the office buildings are in central business districts of the cities. Entity A's management want to apply the revaluation model as per AS 10 (Revised) to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings.
State whether this is acceptable under AS 10 (Revised) or not with reasons?

Solution:

Entity A's management can apply the revaluation model only to the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location.AS 10 (Revised) permits assets to be revalued on a class by class basis.

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement. However, all properties within the class of office buildings must be carried at revalued amount.

Illustration 11
Entity A has a policy of not providing for depreciation on PPE capitalised in the year until the following year, but provides for a full year's depreciation in the year of disposal of an asset. Is this acceptable?

Solution:

The depreciable amount of a tangible fixed asset should be allocated on a systematic basis over its useful life. The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use. Thus, the policy of Entity A is not acceptable.

Illustration 12 (Change in estimate of useful life)
Entity A purchased an asset on 1st January 20X1 for Rs.1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.
On 1st January 20X5, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years.
Calculate the amount of depreciation for each year, if company charges depreciation on Straight Line basis.

Solution:

The entity has charged depreciation using the straight-line method at Rs.10,000 per annum i.e (1,00,000/10 years).

On 1st January 20X5, the asset's net book value is [1,00,000 – (10,000 x 4)] Rs.60,000. The remaining useful life is 4 years.

The company should amend the annual provision for depreciation to charge the unamortised cost over the revised remaining life of four years.

Consequently, it should charge depreciation for the next 4 years at Rs.15,000 per annum i.e. (60,000 / 4 years).

Note: Depreciation is recognised even if the Fair value of the Asset exceeds its Carrying Amount. Repair and maintenance of an asset do not negate the need to depreciate it.

Illustration 13
Entity B constructs a machine for its own use. Construction is completed on 1 st November 20X1 but the company does not begin using the machine until 1 st March 20X2. Comment.

Solution:
The entity should begin charging depreciation from the date the machine is ready for use – that is, 1st November 20X1. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

Illustration 14 (Depreciation where residual value is the same as or close to Original cost)
A property costing Rs.10,00,000 is bought in 20X1. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years. The estimated residual value in 20 years' time, based on 20X1 prices, is:
Case (a) Rs.10,00,000
Case (b) Rs.9,00,000.
Calculate the amount of depreciation.

Solution:
Case (a)
The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost.
There is, therefore, no depreciable amount and depreciation is correctly zero.
Case (b)
The company considers that the residual value, based on prices prevailing at the balance sheet date, will be Rs.9,00,000 and the depreciable amount is, therefore, Rs.1,00,000.
Annual depreciation (on a straight-line basis) will be Rs.5,000 [{10,00,000 – 9,00,000} ÷ 20].

Illustration 15 (Determination of appropriate Depreciation Method)
Entity B manufactures industrial chemicals and uses blending machines in the production process. The output of the blending machines is consistent from year to year and they can be used for different products.
However, maintenance costs increase from year to year and a new generation of machines with significant improvements over existing machines is available every 5 years. Suggest the depreciation method to the management.

Solution:
The straight-line depreciation method should be adopted, because the production output is consistent from year to year.
Factors such as maintenance costs or technical obsolescence should be considered in determining the blending machines' useful life.

Illustration 16 (Gain on replacement of Insured Assets)
Entity A carried plant and machinery in its books at Rs.2,00,000. These were destroyed in a fire. The assets were insured 'New for old' and were replaced by the insurance company with new machines that cost Rs.20,00,000. The machines were acquired by the insurance company and the company did not receive Rs.20,00,000 as cash compensation. State, how Entity A should account for the same?

Solution:

Entity A should account for a loss in the Statement of Profit and Loss on de- recognition of the carrying value of plant and machinery in accordance with AS 10 (Revised).

Entity A should separately recognise a receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 (Revised)* once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

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Test Your Knowledge

1. **As per AS 10 (Revised) 'Property, plant and equipment', which of the following costs is not included in the carrying amount of an item of PPE**
   (a) Costs of site preparation
   (b) Costs of relocating
   (c) Installation and assembly costs.
   (d) initial delivery and handling costs

2. **As per AS 10 (Revised) 'Property, Plant and Equipment', an enterprise holding investment properties should value Investment property**
   (a) as per fair value
   (b) under discounted cash flow model.
   (c) under cost model
   (d) under cash flow model

3. **A plot of land with carrying amount of Rs.1,00,000 was revalued to Rs.1,50,000 at the end of Year 2. Subsequently, due to drop in market values, the land was determined to have a fair value of Rs.1,30,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation?**
   (a) Initial upward valuation of Rs.50,000 credited to Revaluation Reserve. Subsequent downward revaluation of Rs.20,000 debited to P/L.
   (b) Initial upward valuation of Rs.50,000 credited to P/L. Subsequent downward revaluation of Rs.20,000 debited to P/L.
   (c) Initial upward valuation of Rs.50,000 credited to Revaluation Reserve. Subsequent downward revaluation of Rs.20,000 debited to Revaluation Reserve.
   (d) Initial upward valuation of Rs.50,000 debited to P/L. Subsequent downward revaluation of Rs.20,000 credited to P/L.

4. **A plot of land with carrying amount of Rs.1,00,000 was revalued to Rs.90,000 at the end of Year 2. Subsequently, due to increase in market values, the land was determined to have a fair value of Rs.1,05,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation?**
   (a) Initial downward valuation of Rs.10,000 debited to Revaluation Reserve. Subsequent upward revaluation of Rs.15,000 credited to P/L.
   (b) Initial downward valuation of Rs.10,000 debited to P/L. Subsequent upward revaluation of Rs.15,000 credited to P/L.
   (c) Initial downward valuation of Rs.10,000 debited to P/L. Subsequent upward revaluation of Rs.10,000 credited to P/L and Rs.5,000 credited to Revaluation Reserve.
   (d) Initial downward valuation of Rs.10,000 credited to P/L. Subsequent upward revaluation of Rs.10,000 debited to P/L and Rs.5,000 debited to Revaluation Reserve.

5. **On sale of an asset which was revalued upwards, what would be the treatment of Revaluation Reserve?**
   (a) The Revaluation Reserve is credited to P/L since the profit on sale of such asset is now realized.
   (b) The Revaluation Reserve is credited to Retained Earnings as a movement in reserves without impacting the P/L.
   (c) No change in Revaluation Reserve since profit on sale of such asset is already impacting the P/L.

(d) The Revaluation Reserve is reduced from the asset value to compute profit or loss.
6. A machinery was purchased having an invoice price Rs.1,18,000 (including GST Rs.18,000) on 1 April 20X1. The GST amount is available as input tax credit. The rate of depreciation is 10% on SLM basis. The depreciation for 20X2 -X3 would be **(a)** Rs.10,000. **(b)** Rs.11,800. **(c)** Rs.9,000. **(d)** Rs.10,500.

Answer to the Multiple Choice Questions

1.	(b)	2.	(c)	3.	(c)	4.	(c)	5.	(b)	6.	(a)

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Theoretical Questions

7. A company changed its method of depreciation from SLM to WDV. How should the change be recognised?

Answer:

As per AS 10, Property, Plant and Equipment, the depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

Accordingly, the change in method of depreciation should be accounting for as a change in accounting estimate, prospectively.

8. A company has debited the Building Account with the Cost of the Land on which the building stands and has provided depreciation on such total cost. Comment on the accounting treatment.

Answer:

As per AS 10, Property, Plant and Equipment, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. Further, Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets.

In the given case, land should not be depreciated unless it has a limited useful life. Accordingly, it is incorrect to debit the cost of land to the Building Account and provide depreciation on the aggregate cost.

9. An entity is setting up a manufacturing plant. Construction of the plant is completed in August and the plant is ready for commercial production in November. However the entity commences production in March. When should be company start charging depreciation?

Answer:

As per AS 10, Property, Plant and Equipment, depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, since the plant is ready for commercial production in November, depreciation shall commence from November. The date of commencement of commercial production is irrelevant for charging depreciation.

10. Which factors should be considered by a company while determining useful life?

Answer:

All the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the expected capacity or physical output of the asset.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

11. An entity gave the following Note in its Financial Statements:

'The company chooses not to charge depreciation on Property, Plant and Equipment on account of:

(a) Annual Maintenance Contracts being expensed thereby ensuring timely repairs of Plant and Machinery.

(b) Depreciation being a non-cash expense has no impact on cash flows. Accordingly, it is not necessary to depreciate an asset when repairs and maintenance charges are expensed in the Statement of Profit and Loss.

(c) The values of certain assets like Property increase with passage of time, and hence charging depreciation does not make sense.

(d) At the end of the useful life, the asset is ultimately sold, and since the asset is at cost due to no depreciation, exact profit or loss on sale of the asset is stated.'

You are required to state the appropriateness of the above accounting policy in line with the relevant Accounting Standards.

Answer:

Depreciation refers to writing off the value of the asset over its useful life. Such write-off is necessitated on account of normal wear-and-tear, usage, or obsolescence. Since items of Property, Plant and Equipment are generally used in generating revenue, the pro-rated write-off in value of such item should be recorded in the books against the income earned by such an asset.

Providing depreciation is mandatory, in spite of the fact that repairs are expensed in the Statement of Profit and Loss, or the value of the Property is appreciating. Depreciation is a systematic allocation of cost of the asset against the income generated from the continued use of the asset. Further, the Companies Act, 2013 mandates depreciation to be charged in order to determine the correct profits. Thus, not charging depreciation would result in non-compliance with the Companies Act provisions as well.

The argument laid down by the company and the reasons for the same being invalid are discussed below.

(a) Annual Maintenance Contracts being expensed thereby ensuring timely repairs of Plant and Machinery:

The fact that the company enters into Annual Maintenance Contracts for timely repairs can be regarded as a running cost. Such expense is incurred in order to ensure that the machine continues to run as intended. Thus, it implies that because the machine is being utilized, it will need regular repairs. In other words, continuous use is resulting in normal wear-and-tear which is the reason why depreciation should be charged by the company. By stating that the company incurs Annual Maintenance Expenses, the company is recording only the 'maintenance expenses', but not the wear-and-tear requiring the maintenance in the first place. Hence, this argument put forth by the company is not valid.

(b) Depreciation being a non-cash expense has no impact on cash flows. Accordingly, it is not necessary to depreciate an asset when repairs and maintenance charges are expensed in the Statement of Profit and Loss.

When viewed from the prism of depreciation alone, it appears that the fact that depreciation is a non-cash item is correct. However, it must be noted that at the time of procurement of the asset, the company would have paid cash. Depreciation is after all writing off this amount over the life of the asset. Hence the argument that depreciation is a non-cash item is not valid. Depreciation is writing off the cost of the asset (which was already paid for) over the useful life of the asset, and hence is mandatory.

(c) The values of certain assets like Property increase with passage of time, and hence charging depreciation does not make sense.

Certain assets like immovable property do increase in value with the passage of time. However, such assets are 'used for the purposes of business' and are not 'held for sale' or held as investment property. Accordingly, since the asset is being used for carrying on business, providing depreciation will give a true and fair view of the results of the company, and hence the argument that the value of the property appreciates is not valid.

If the company wants to show the fair market value of the PPE, then it has the option to apply Revaluation model. However, depreciation is mandatory to be charged in Revaluation model also.

(d) At the end of the useful life, the asset is ultimately sold, and since the asset is at cost due to no depreciation, exact profit or loss on sale of the asset is stated.'

The value of any asset, after usage, will reduce. Accordingly, the argument that the 'exact profit or loss on sale of the asset' will be obtained is incorrect. Due to usage of the asset, the value of the asset would be lower than the cost. Charging depreciation would seek to bring the book value approximating to such reduced value. Thereafter, on sale of the asset, the true profit or loss would be available. Accordingly, this argument is also invalid.

It may be pertinent to note that Accounting Standard 1, Disclosure of Accounting Policies states that Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts. In other words, the company cannot be absolved of the fact that it has not complied with the relevant accounting standards merely by giving a disclosure of incorrect policies or practices being followed.

Thus, the company's stand of disclosing the incorrect policy as a remedy is not correct. The company is suggested to charge depreciation on a systematic basis over the useful life of the asset thereby complying with the Accounting Standards.

Scenario Based Questions

12. With reference to AS-10 Revised, classify the items under the following heads:

HEADS

(i) Purchase Price of Property, plant and Equipment (PPE)

(ii) Directly attributable cost of PPE or

(iii) Cost not included in determining the carrying amount of an item of PPE.

ITEMS

(1) Import duties and non-refundable purchase taxes.

(2) Initial delivery and handling costs.

(3) Initial operating losses, such as those incurred while demand for the output of an item builds up.

(4) Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.

(5) Trade discounts and rebates.

(6) Costs of relocating or reorganizing part or all of the operations of an enterprise.

(7) Installation and assembly costs.

(8) Administration and other general overhead costs.

Answer:

Heads

(i) Purchase price of PPE

(ii) Directly attributable cost of PPE

(iii) Cost not included in determining the carrying amount of an item of PPE

	Items	Classified under Head
1	Import duties and non-refundable purchase taxes	(i)
2	Initial delivery and handling costs	(ii)
3	Initial operating losses, such as those incurred while demand for the output of an item builds up	(iii)
4	Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.	(iii)
5	Trade discounts and rebates (deducted for computing purchase price)	(i)
6	Costs of relocating or reorganizing part or all of the operations of an enterprise.	(iii)
7	Installation and assembly costs	(ii)
8	Administration and other general overhead costs	(iii)

13. ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

1.	Cost of the plant (cost per supplier's invoice plus taxes)	Rs.25,00,000
2.	Initial delivery and handling costs	Rs.2,00,000
3.	Cost of site preparation	Rs.6,00,000
4.	Consultants used for advice on the acquisition of the plant	Rs.7,00,000
5.	Interest charges paid to supplier of plant for deferred credit	Rs.2,00,000
6.	Estimated dismantling costs to be incurred after 7 years	Rs.3,00,000
7.	Operating losses before commercial production	Rs.4,00,000

Please advise ABC Ltd. on the costs that can be capitalised in accordance with AS 10 (Revised).

Answer:

According to AS 10 (Revised), these costs can be capitalised:

1.	Cost of the plant	Rs.25,00,000
2.	Initial delivery and handling costs	Rs.2,00,000
3.	Cost of site preparation	Rs.6,00,000
4.	Consultants' fees	Rs.7,00,000
5.	Estimated dismantling costs to be incurred after 7 years	Rs.3,00,000
		Rs.43,00,000

Note: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of Rs.2,00,000 and operating losses before commercial production amounting to Rs.4,00,000 are not regarded as directly attributable costs and thus cannot be capitalised. They should be written off to the Statement of Profit and Loss in the period they are incurred.

14. Arka Ltd. purchased machinery for Rs.3,000 lakhs. Depreciation was charged at 10% on SLM basis for a useful life of 10 years. At the end of Year 4, the machinery was revalued to Rs.2,700 lakhs and the same was adopted. What will be the carrying amount of the asset at the end of Year 5 and Year 6? Assume no change in the useful life.

Answer:

Particulars	Rs.in lakhs
Original Cost of the Asset	3,000.00
Less: Depreciation for 4 years (Rs.3,000 lakhs x 10% x 4 years)	(1,200.00)
Book Value at the end of Year 4	1,800.00
Add: Revaluation Surplus (balancing figure)	900.00
Revalued Amount as given (= revised depreciable value)	2,700.00
Less: Depreciation for Year 5 (Rs.2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 5	2,250.00
Less: Depreciation for Year 6 (Rs.2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 6	1,800.00

15. Skanda Ltd. acquired a machinery for Rs.2,50,00,000 five years ago. Depreciation was charged at 10% p.a. on SLM basis, useful life being 10 years. At the beginning of Year 3, the machinery was revalued to Rs.3,00,00,000 with the surplus on revaluation being credited to Revaluation Reserve. Depreciation was provided on the revalued amount over the balance useful life of 8 years. The machinery was sold in the current year for Rs.1,12,50,000. Give the accounting treatment for the above in the Company's accounts. What will be the treatment if the machinery fetched only Rs.42,50,000 now?

Answer:

Particulars	Rs.
Original Cost of the Asset	2,50,00,000
Less: Depreciation for 2 years (Rs.2,50,00,000 x 10% x 2 years)	50,00,000

Book Value at the beginning of Year 3	2,00,00,000
Add: Revaluation Surplus (balancing figure)	1,00,00,000
Revalued Amount as given (= revised depreciable value)	3,00,00,000
Less: Depreciation for Years 3-5 (Rs.3,00,00,000 ÷ 8 yrs x 3 yrs)	1,12,50,000
Carrying Amount at the end of Year 5	1,87,50,000

The treatment of Gain / Loss on Disposal / Revaluation is as below:

Particulars	Disposal Proceeds = Rs.1,12,50,000	Disposal Proceeds = Rs.42,50,000
Book Value Less Disposal Proceeds = Loss recognized in Profit or Loss	Rs.1,87,50,000 – Rs.1,12,50,000 = Rs.75,00,000 (Loss)	Rs.1,87,50,000 – Rs.42,50,000 = Rs.1,45,00,000 (Loss)
Revaluation Surplus directly transferred to Retained Earnings	Rs.1,00,00,000	Rs.1,00,00,000

16. Akshar Ltd. installed a new Plant (not a qualifying asset), at its production facility, and incurred the following costs:

- **Cost of the Plant (as per supplier's invoice): Rs.30,00,000**
- **Initial delivery and handling costs: Rs.1,00,000**
- **Cost of site preparation: Rs.2,00,000**
- **Consultant fee for advice on acquisition of Plant: Rs.50,000**
- **Interest charges paid to supplier against deferred credit: Rs.1,00,000**
- **Estimate of Dismantling and Site Restoration costs: Rs.50,000 after 10 years (Present Value is Rs.30,000)**
- **Operating losses before commercial production: Rs.40,000**

The company identified motors installed in the Plant as a separate component and a cost of Rs.5,00,000 (Purchase Price) and other costs were allocated to them proportionately. The company estimates the useful life of the Plant and those of the Motors as 10 years and 6 years respectively and SLM method of Depreciation is used.

At the end of Year 4, the company replaces the Motors installed in the Plant at a cost of Rs.6,00,000 and estimated the useful life of new motors to be 5 years. Also, the company revalued its entire class of Fixed Assets at the end of Year 4. The revalued amount of Plant as a whole is Rs.25,00,000. At the end of Year 8, the company decides to retire the Plant from active use and also disposed the Plant as a whole for Rs.6,00,000.

There is no change in the Dismantling and Site Restoration liability during the period of use. You are required to explain how the above transaction would be accounted in accordance with AS 10.

Answer:

1. Cost at Initial Recognition:

Particulars	Rs.
Cost of the Plant (as per Invoice)	30,00,000
Initial Delivery and Handling Costs	1,00,000
Cost of Site Preparation	2,00,000
Consultants' Fees	50,000
Estimated Dismantling and Site Restoration Costs	30,000

Total Cost of Plant including Motors	33,80,000
Less: Cost of Motors identified as a separate component (1/6)*	5,63,333
Cost of the Plant (excluding Motors – balance 5/6)	28,16,667

* Purchase price of Motors = Rs.5,00,000 out of Rs.30,00,000 i.e., 1/6 of value of Plant

Note: Since the asset is not a qualifying asset, payment of interest to the supplier is not capitalized. Further, operating losses of Rs.40,000 incurred before commercial production is not a directly attributable cost, and hence excluded from cost of asset. These costs are expensed to the P/L as and when they are incurred.

2. **Recognition of Motors Replacement**

Particulars	Rs.
Cost of Motors determined above	5,63,333
Less: Depreciation for 4 years (as per SLM)	3,75,555
5,63,333 ÷ 6 years x 4 years	
Carrying Amount of Motors at the end of Year 4	1,87,778

Accounting: The company should derecognize the existing Carrying Amount of Motors replaced of Rs.1,87,778. Further, the acquisition cost of new motors of Rs.6,00,000 would be capitalized as a separate component. This amount will be depreciated over the next 5 years at Rs.6,00,000 ÷ 5 years = Rs.1,20,000 p.a.

3. **Revaluation**

Particulars	Rs.
Cost of the Plant at initial recognition [from (1) above]	28,16,667
Less: SLM Depreciation for 4 years: Rs.28,16,667 ÷ 10 years x 4 years	11,26,667
Carrying Amount of Plant at the end of Year 4	16,90,000
Revalued Amount of Plant (Excluding Motors, since the same is treated as a separate component: Rs.25,00,000 – Rs.6,00,000)	19,00,000
Therefore, Gain on Revaluation credited to Revaluation Reserve	**2,10,000**
Revised Depreciation Charge p.a.: 19,00,000 ÷ 6 years	**3,16,667**

4. **Derecognition**

Particulars	Motors	Plant (excluding Motors)
Cost / Revalued Amount at end of Year 4	6,00,000	19,00,000
Less: Depreciation for Years 5-8	1,20,000 x 4 = 4,80,000	3,16,667 x 4 =12,66,668
Carrying Amount before Disposal / De-recognition	1,20,000	6,33,332
Less: Disposal Proceeds Rs.6,00,000 allocated in ratio of carrying amount	95,575	5,04,425
Loss to be written off to P/L	**24,425**	**1,28,907**

17. Bharat Infrastructure Ltd. acquired a heavy machinery at a cost of Rs.1,000 lakhs, the breakdown of its components is not provided. The estimated useful life of the machinery is 10 years. At the end of Year 6, the turbine, which is a major component of the machinery, needed replacement, as further usage and maintenance was uneconomical. The remainder of the machine is in good condition and is expected to last for the remaining 4 years. The cost of the new turbine is Rs.450 lakhs. Give the accounting treatment for the new turbine,

assuming SLM Depreciation and a discount rate of 8%. (RTP Jan 25)

Answer:

As per AS 10, Property, Plant and Equipment, the derecognition of the carrying amount of components of an item of Property, Plant and Equipment occurs regardless of whether the cost of the previous part / inspection was identified in the transaction in which the item was acquired or constructed. If it is not practicable for an enterprise to determine the carrying amount of the replaced part/ inspection, it may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/ existing inspection component was when the item was acquired or constructed.

In the given case, the new turbine will produce economic benefits to Bharat Infrastructure Ltd. and the cost is measurable. Since the recognition criteria is fulfilled, the same should be recognised as a separate item of Property, Plant and Equipment. However, since the initial breakup of the components is not available, the cost of the replacement of Rs.450 lakhs can be used as an indication based on the guidance given above, discounted at 8% for the 6- year period lapsed.

Thus, estimate of cost 6 years back = Rs.450 lakhs ÷ 1.08^6 = Rs.283.58 lakhs Current carrying amount of turbine (to be de-recognised) = Estimated cost Rs.

283.58 lakhs (-) SLM depreciation at 10% (useful life 10 years) for 6 years

Rs.170.15 lakhs= Rs.113.43 lakhs.

Hence revised carrying amount of the machinery will be as under:

Particulars	Rs.in lakhs
Historical Cost [Rs.1,000 lakhs (-) SLM Depreciation at 10% (10 year life) for 6 years]	400.00
Add: Cost of new turbine	450.00
Less: Derecognition of current carrying amount of old turbine	(113.43)
New Carrying Amount of Machinery	736.57

18. Preet Ltd. intends to set up a steel plant, for which it has acquired a dilapidated factor having an area of 5,000 acres at a cost of ₹ 60,000 per acre. Preet Ltd. has incurred Rs.1.10 crores on demolishing the old Factory Building thereon. A sum of Rs.63,00,000 (including 5% GST thereon) was realized from the sale of material salvaged from the site. Preet Ltd. incurred Stamp Duty and Registration Charges of 7% of land value, paid legal and consultancy charges Rs.8,00,000 for land acquisition and incurred Rs.1,25,000 on title guarantee insurance. Compute the value of the land acquired.

Answer:

Particulars	Rs.
Purchase Price: 5,000 acres x Rs.60,000 per acre	3,000.00
Stamp Duty and Registration Charges at 7%	210.00
Legal and Consultancy Fees	8.00
Title Guarantee Insurance	1.25
Demolition Expenses (Net of Salvage Income) [Rs.110 lakhs (-)Rs.60 lakhs (Rs.63 lakhs x 100/105)]	50.00
Cost of Land	3,269.25

19. Star Limited purchased machinery for Rs. 6,80,000 (inclusive of GST of Rs.40,000). Input credit is available for entire amount of GST paid. The company incurred the following other expense for installation.

	Rs.
Cost of preparation of site for installation	21,200
Total Labour charges	56,000
(200 out of the total of 500 men hours worked, were spent on installation of the machinery)	
Spare parts and tools consumed in installation	5,000
Total salary of supervisor	26,000
(Time spent for installation was 25% of the total time worked)	
Total technical expense	34,000
(1/10 relates to the plant installation)	
Test run and experimental production expenses	18,000
Consultancy charges to architect for plant set up	11,000
Depreciation on assets used for installation	12,000

The machine was ready for use on 15.01.20X1 but was used from 01.02.20X1. Due to this delay further expenses of Rs.8,900 were incurred. Calculate the value at which the plant should be capitalized in the books of Star Limited.

Answer:

Calculation of Cost of Plant

Particulars		Rs.
Purchase Price	Given	6,80,000
Add: Site Preparation Cost	Given	21,200
Labour charges	(56,000×200/500) Given	22,400
Spare parts		5,000
Supervisor's Salary	25% of Rs.26,000	6,500
Technical costs	1/10 of Rs.34,000	3,400
Test run and experimental production charges	Given	18,000
Architect Fees for set up	Given	11,000
Depreciation on assets used for installation	Given	12,000
Total Cost of Asset		7,79,500
Less: GST credit receivable		(40,000)
Value to be capitalized		7,39,500

Note: Further Expenses of Rs.8,900 from 15.1.20X1 to 1.2.20X1 to be charged to profit and loss A/c as plant was ready for production on 15.1.20X1.

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: ABC Ltd. has entered into a binding agreement with XYZ Ltd. to buy a custom-made machine amounting to Rs. 4,00,000. As on 31st March, 2020 before delivery of the machine, ABC Ltd. had to change its method of production. The new method will not require the machine ordered and so it shall be scrapped after delivery. The expected scrap value is 'NIL'. Show the treatment of machine in the books of ABC Ltd. (MTP Mar 22)

Answer:

A liability is recognized when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, ABC Ltd. should recognize a liability of ₹ 4,00,000 payable to XYZ Ltd. When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognized as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognized as an expense. Hence ABC Ltd. should charge the amount of ₹ 4,00,000 (being loss due to change in production method) to Profit and loss statement and record the corresponding liability (amount payable to XYZ Ltd.) for the same amount in the books for the year ended 31st March, 2020.

Question 2: RS Ltd. has acquired a heavy plant at a cost of ₹ 2,00,00,000. The estimated useful life is 10 years. At the end of the 2nd year, one of the major components i.e., the Boiler has become obsolete (which was acquired at price of ₹ 50,00,000) and requires replacement, as further maintenance is uneconomical. The remainder of the plant is perfect and is expected to last for next 8 years. The cost of a new boiler is ₹ 60,00,000. Can the cost of the new boiler be recognised as an asset, and, if so, what should be the carrying value of the plant at the end of second year? (RTP Nov'22)

Answer:

Recognition of Asset: The new boiler will produce economic benefits to RS Ltd., and the cost is measurable. Hence, the item should be recognized as an asset. The cost old boiler should be de-recognized and the new boiler will be added.

Statement showing cost of new boiler and machine after year 2

Original cost of plant	₹ 2,00,00,000
Less: Accumulated depreciation [(2,00,00,000 /10) x 2]	₹ 40,00,000
Carrying value of the plant after two years	₹ 1,60,00,000
Less: Current Cost of Old Boiler to be derecognized	
Less: WDV of Boiler (replaced) after 2 years (50,00,000/10 x 8)	₹ 40,00,000
	₹ 1,20,00,000
Add: Cost of new Boiler to be recognized	₹ 60,00,000
Revised carrying amount of Plant	₹ 1,80,00,000

Question 3: XYZ Limited provided you the following information for the year ended 31 st March, 2022.

(i) The carrying amount of a property at the end of the year amounted to ₹ 2,16,000 (cost/value ₹ 2,50,000 and accumulated depreciation ₹ 34,000). On this date the property was revalued and was deemed to have a fair value of ₹ 1,90,000. The balance in the revaluation surplus relating to a previous revaluation gain for this property was ₹ 20,000.

You are required to calculate the revaluation loss as per AS 10 (Revised) and give its

treatment in the books of accounts.

(ii) An asset that originally cost ₹ 76,000 and had accumulated depreciation of ₹ 62,000 was disposed of during the year for ₹ 4,000 cash.

You are required to explain how the disposal should be accounted for in the financial statements as per AS 10 (Revised). (PYP May '22)

Answer:

(i) As per AS 10, a decrease in the carrying amount of an asset arising on revaluation should be charged to the statement of profit and loss. However, the decrease should be debited directly to owners' interests under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Calculation of revaluation loss and its accounting treatment

		₹
Carrying value of the asset as on 31st March, 2022	a	2,16,000
Revalued amount of the asset	b	(1,90,000)
Total revaluation loss on asset	c=a–b	26,000
Adjustment of previous revaluation reserve	d	(20,000)
Net revaluation loss to be charged to the Profit and loss account	e=c–d	6,000

(ii) AS 10 states that the carrying amount of an item of property, plant and equipment is derecognized on disposal of the asset. It further states that the gain or loss arising from the derecognition of an item of property, plant and equipment should be included in the statement of profit and loss when the item is derecognized. Gains should also not be classified as revenue.

Calculation of loss on disposal of the asset and its accounting treatment

		₹
Original cost of the asset	a	76,000
Accumulated depreciation till date	b	62,000
Carrying value of the asset as on 31st March, 2022	c=a–b	14,000
Cash received on disposal of the asset	d	4,000
Loss on disposal of asset charged to the Profit and loss account	e=c–d	10,000

Question 4: In the books of Top maker Limited, carrying amount of Plant and Machinery as on 1stApril, 2022 is ₹ 56,30,000.

On scrutiny, it was found that a purchase of Machinery worth ₹ 21,12,000 was included in the purchase of goods on 1stJune, 2022. On 30thJune, 2022 the company disposed a Machine having book value of ₹ 9,60,000 (as on 1stApril, 2022) for ₹ 8,25,000 in part exchange of a new machine costing ₹ 15,65,000. The company charges depreciation @ 10% p.a. on written down value method on Plant and Machinery.

You are required to compute:

(i) Depreciation to be charged to Profit & Loss Account;

(ii) Book value of Plant & Machinery as on 31stMarch, 2023; and

(iii) Profit/Loss on exchange of Plant & Machinery. (PYP May '23)

Answer:

i) Depreciation to be charged in the Profit & Loss Account

Particulars	Amount in ₹
Depreciation on old Machinery	1,40,750
[10% on ₹ 56,30,000 for 3 months (01.04.2022 to 30.06.2022)]	

Add: Depreciation on Machinery acquired on 01.06.2022	1,76,000
(₹21,12,000 X 10% X10/12) Add: Depreciation on Machinery after adjustment of Exchange [10% of ₹ 56,30,000 – 9,60,000 + 15,65,000) for 9 months]	4,67,625
Total Depreciation to be charged in Profit & Loss A/c	**7,84,375**

ii) Book value of Plant & Machinery as on 31.3.2023

Particulars		Amount in ₹
Balance as per books on 01.04.2022		56,30,000
Add: Included in purchases on 01.06.2022	21,12,000	
Add: Purchases on 30.06.2022	15,65,000	36,77,000 93,07,000
Less: Book value of Machine sold on 30.06.2022		(9,60,000) 83,47,000
Less: Depreciation on Machinery in use ₹ (7,84,375 –24,000)		(7,60,375)
Book Value as on 31.03.2023		75,86,625

Note: The computation of depreciation and book value of Plant & Machinery can be presented in the following alternative manner:

Particulars	Book Value or Cost or Acquisition	Period	Depreciation	Book Value as on 31.03.2023
Opening Value	46,70,000 (56,30,000 – 9,60,000)	01.04.2022 to 31.03.2023	4,67,000 (46,70,000 x 10%)	42,03,000
Sold	9,60,000	01.04.2022 to 30.06.2022	24,000 (9,60,000 x 10% x 3/12)	-
Purchases	21,12,000	01.06.2022 to 31.03.2023	1,76,000 (21,12,000 x 10% x 10/12)	19,36,000
New Machinery	15,65,000	01.07.2022 to 31.03.2023	1,17,375 (15,65,000 x 10% x 9/12)	14,47,625
Total			7,84,375	75,86,625

iii) Profit/Loss on Exchange of Machinery

Particulars	Amount in
Balance as per books on 01.04.2022	9,60,000
Less: Depreciation for 3 months (₹ 9,60,000 x 10 /100 x 3 / 12)	(24,000)
W.D.V. as on 30.06.2022	9,36,000
Less: Exchange value	(8,25,000)
Loss on Exchange of Machinery	1,11,000

Question 5: Shrishti Ltd. contracted with a supplier to purchase machinery which is to be installed in its Department A in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were Rs. 1,41,870. These activities were supervised by a

technician during the entire period, who is employed for this purpose of Rs. 45,000 per month. The technician's services were given by Department B to Department A, which billed the services at Rs. 49,500 per month after adding 10% profit margin.
The machine was purchased at Rs. 1,58,34,000 inclusive of IGST @ 12% for which input credit is available to Shrishti Ltd. Rs. 55,770 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of Rs. 30,000 to supervise machinery installation at the factory site.
Ascertain the amount at which the Machinery should be capitalized under AS 10 considering that IGST credit is availed by the Shristhi Limited. Internally booked profits should be eliminated in arriving at the cost of machine. (RTP May '25)

Answer:

Calculation of Cost of Fixed Asset (i.e. Machinery)

Particulars		Rs.
Purchase Price	Given (Rs. 158,34,000 x 100/ 112)	1,41,37,500
Add: Site Preparation Cost	Given	1,41,870
Technician's Salary	Specific/Attributable overheads for 3 months (See Note) (45,000 x 3)	1,35,000
Initial Delivery Cost	Transportation	55,770
Professional Fees for Installation	Architect's Fees	30,000
Total Cost of Asset		1,45,00,140

Question 6: 12. Precision Tools Ltd. provides the following details related to its fixed assets for the year ended 31st March 2025:
The company purchased a machine for ₹ 12,00,000 on 1st October 2024. The following expenses were also incurred:
Freight and insurance: ₹ 60,000
Erection charges: ₹ 40,000
Testing Cost: Raw materials used ₹ 25,000,
Wages ₹10,000,
Sale of finished goods from testing production ₹ 8,000.
On 1st December 2024, it replaced the motor of an old machine with a new one costing ₹1,20,000, improving the output capacity by 15%. The old motor had a Cost of ₹50,000 and Accumulated Depreciation of ₹ 35,000.
On 15th March 2025, the company shifted a machine from one factory to another. It incurred the following:
Dismantling cost: ₹12,000
Transport and installation: ₹18,000
Loss due to damage in transit: ₹6,000
You are required to calculate the amount to be capitalized for each of the above cases as per AS 10. (RTP Sept 25)

Answer:

As per AS 10, Property, Plant and Equipment, the cost of an item of PPE includes:
(a) Purchase price including import duties and non-refundable taxes,
(b) Directly attributable costs to bring the asset to working condition (e.g., transport, installation, trial run),

(c) Any trial run net costs (i.e., cost – recoverable proceeds).

Particulars	Amount (₹)
Purchase Price	12,00,000
Freight & Insurance	60,000
Erection Charges	40,000
Net Cost of Testing (25,000 + 10,000 – 8,000)	27,000
Cost of Machinery	13,27,000

Recognition of Motors Replacement

Particulars	₹
Cost of Motors	50,000
Less: Depreciation	35,000
Carrying Amount of Motors	15,000

Accounting: The company should derecognize the existing Carrying Amount of Motors replaced of ₹ 15,000. Further, the acquisition cost of new motors of ₹ 1,20,000 would be capitalized as a separate component.

Costs of relocating or reorganising part or all of the operations of an enterprise are not included in the carrying amount of an item of PPE. Hence Costs of relocation of ₹ 36,000 (12,000 +18,000 +6,000) of PPE are not capitalized. Thus, entire expense to be charged off to Profit and Loss A/c.

Thus, total capitalization (net off derecognition) = 14,32,000 (13,27,2000 +1,20,000-15,000).

Question 7: Hardy Ltd. intends to extend the factory set up on the adjacent plot with disintegrated old premises. It acquired the land having an area of 250 hectares at a cost of ₹ 25,000 per hectare.

Hardy Ltd. incurred Stamp duty and registration charges of 5% of land value. Legal fees were paid ₹ 4,75,000 for land acquisition.

Hardy Ltd. incurred ₹ 37,85,000 for demolishing old premises thereon. A sum of ₹ 12,60,000 (including 5% GST thereon) was realized from the sale of material salvaged from the site.

Till the new site with extended factory premises is ready, the company needs to move the present production facilities to another (temporary) site. The following incremental costs will be incurred.

(1) Set up costs of ₹ 7,50,000 to install machinery in the new location.

(2) Rent of ₹ 12,00,000.

(3) Removal costs of ₹ 2,50,000 to transport the machinery from the old location to the temporary location.

(i) Management is of the opinion that the cost of moving the production facilities to another temporary location can be capitalised.

You are required to advise.

(ii) You are also required to compute the cost of land acquired. (PYP May 25 7M)

Answer:

(i)

(i) Constructing or acquiring a new asset may result in incremental costs that would have been avoided if the asset had not been constructed or acquired.

(ii) These costs are not to be included in the cost of the asset if they are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(iii) The costs to be incurred by the company are in the nature of costs of relocating or reorganising operations of the company and do not meet the requirement of AS 10 (Revised)

(iv) Therefore, these costs cannot be capitalized.

(ii) Computation of cost of land

Particulars	₹		₹
Purchase Price	250 hectares x ₹ 25,000 per hectares		62,50,000
Stamp Duty and Registration Charges	5% of ₹ 62,50,000		3,12,500
Legal and Consultancy Fees			4,75,000
Demolition Expenses (Net of Salvage Income)	₹ 12,60,000 x (100/105)	37,85,000 (12,00,000)	25,85,000
Cost of Land			96,22,500

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AS – 11: The Effects of changes in Foreign Exchange Rates

Illustrations

Illustration 1

Classify the following items as monetary or non-monetary item:

Inventories

Trade Receivables

Investment in Equity shares

Property, Plant and Equipment.

Solution:

Inventories	Non-monetary
Trade receivables	Monetary
Investment in equity shares	Non-monetary
Property, Plant and Equipment	Non-monetary

Illustration 2

	Exchange Rate per $
Goods purchased on 1.1.20X1 for US $ 15,000	**Rs.75**
Exchange rate on 31.3.20X1	**Rs.74**
Date of actual payment 7.7.20X1	**Rs.73**

You are required to ascertain the loss/gain to be recognized for financial years ended 31st March, 20X1 and 31st March, 20X2 as per AS 11.

Solution:

As per AS 11 on 'The Effects of Changes in Foreign Exchange Rates', all foreign currency transactions should be recorded by applying the exchange rate on the date of transactions. Thus, goods purchased on 1.1.20X1 and corresponding creditors would be recorded at Rs.11,25,000 (i.e. $15,000 × Rs.75)

According to the standard, at the balance sheet date all monetary transactions should be reported using the closing rate. Thus, creditors of US $15,000 on 31.3.20X1 will be reported at Rs.11,10,000 (i.e. $15,000 × Rs.74) and exchange profit of Rs.15,000 (i.e. 11,25,000 – 11,10,000) should be credited to Profit and Loss account in the year ended 31st March, 20X1.

On 7.7.20X1, creditors of $15,000 is paid at the rate of Rs.73. As per AS 11, exchange difference on settlement of the account should also be transferred to Profit and Loss account. Therefore, Rs.15,000 (i.e. 11,10,000 – 10,95,000) will be credited to Profit and Loss account in the year ended 31st March, 20X2.

Illustration 3

Kalim Ltd. borrowed US$ 4,50,000 on 01/01/20X1, which will be repaid as on 31/07/20X1. Kalim Ltd. prepares financial statement ending on 31/03/20X1. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/20X1 1 US$ = Rs.48.00

31/03/20X1 1 US$ = Rs.49.00

31/07/20X1 1 US$ = Rs.49.50

Solution:

Journal Entries in the Books of Kalim Ltd.

Date	Particulars		Rs.(Dr.)	Rs.(Cr.)
20X1			216,00,000	
Jan. 01	Bank Account (4,50,000 x 48)	Dr.		
	To Foreign Loan Account			216,00,000
March 31	Foreign Exchange Difference Account	Dr.	4,50,000	
	To Foreign Loan Account			4,50,000
	[4,50,000 x (49-48)]			
July 01	Foreign Exchange Difference Account	Dr.	2,25,000	
	[4,50,000 x (49.5-49)]			
	Foreign Loan Account	Dr.	220,50,000	
	To Bank Account			2,22,75,000

Illustration 4

Rau Ltd. purchased a plant for US$ 1,00,000 on 01st February 20X1, payable after three months. Company entered into a forward contract for three months @ Rs.49.15 per dollar. Exchange rate per dollar on 01st Feb. was Rs.48.85. How will you recognise the profit or loss on forward contract in the books of Rau Ltd.?

Solution:

Forward Rate	Rs.49.15
Less: Spot Rate	(Rs.48.85)
Premium on Contract	Rs.0.30
Contract Amount	US$ 1,00,000
Total Loss (1,00,000 x 0.30)	Rs.30,000

Contract period 3 months (2 months falling in the year ended 31st March, 20X1)

Loss to be recognised (30,000/3) x 2 = Rs.20,000 in the year ended 31st March, 20X1. Rest Rs.10,000 will be recognised in the following year.

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 5

Mr. A bought a forward contract for three months of US$ 1,00,000 on 1st December at 1 US$ = Rs.47.10 when exchange rate was US$ 1 = Rs.47.02. On 31st December when he closed his books exchange rate was US$ 1 = Rs.47.15. On 31st January, he decided to sell the contract at Rs.47.18 per dollar. Show how the profits from contract will be recognised 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	Rs.47.18
Less: Contract Rate	(Rs.47.10)
Premium on Contract	Rs.0.08
Contract Amount	US$ 1,00,000

Total Profit (1,00,000 x 0.08)	Rs.8,000

Illustration 6

Assets and liabilities and income and expenditure items in respect of foreign branches (integral foreign operations) 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 the statement of profit and loss. 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 AS 11. 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.

Illustration 7

A business having the Head Office in Kolkata has a branch in UK. The following is the trial balance of Branch as at 31.03.20X4:

Account Name	Amount in £	
	Dr.	Cr.
Machinery (purchased on 01.04.20X1)	5,000	
Debtors	1,600	
Opening Stock	400	
Goods received from Head Office Account	6,100	
(Recorded in HO books as Rs.4,02,000)		
Sales		20,000
Purchases	10,000	

Wages	1,000	
Salaries	1,200	
Cash	3,200	
Remittances to Head Office (Recorded in HO books as Rs.1,91,000)	2,900	
Head Office Account (Recorded in HO books as Rs.4,90,000)		7,400
Creditors		4,000

- Closing stock at branch is £ 700 on 31.03.20X4.
- Depreciation @ 10% p.a. is to be charged on Machinery.
- Prepare the trial balance after been converted in Indian Rupees.
- Exchange rates of Pounds on different dates are as follow:

01.04.20X1– Rs.61; 01.04.20X3– Rs.63 & 31.03.20X4 – Rs.67

Solution:

Trial Balance of the Foreign Branch converted into Indian Rupees as on March 31, 20X4

Particulars	£ (Dr.)	£ (Cr.)	Conversion Basis	Rs. (Dr.)	Rs. (Cr.)
Machinery	5,000		Transaction date rate	3,05,000	
Debtors	1,600		Closing Rate	1,07,200	
Opening Stock	400		Opening Rate	25,200	
Goods Received from HO	6,100		Actuals	4,02,000	
Sales		20,000	Average Rate		13,00,000
Purchases	10,000		Average Rate	6,50,000	
Wages	1,000		Average Rate	65,000	
Salaries	1,200		Average Rate	78,000	
Cash	3,200		Closing Rate	2,14,400	
Remittance to HO	2,900		Actuals	1,91,000	
HO Account		7,400	Actuals		4,90,000
Creditors		4,000	Closing Rate		2,68,000
Exchange Rate Difference			Balancing Figure	20,200	
	31,400	31,400		20,58,000	20,58,000
Closing Stock	700		Closing Rate	46,900	
Depreciation	500		Fixed Asset Rate	30,500	

Illustration 8

A Ltd. purchased fixed assets costing Rs.3,000 lakhs on 1.1.20X1 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs.40.00 and Rs.42.50 as on 1.1.20X1 and 31.12.20X1 respectively. First instalment was paid on 31.12.20X1. The entire difference in foreign exchange has been capitalised.

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

As per AS 11 '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 recognised 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 recognised as income or expense.

Solution:

Calculation of Exchange Difference:

Foreign currency loan = Rs.3,000 lakhs / Rs.40 = 75 lakhs US Dollars

Exchange difference = 75 lakhs US Dollars x (42.50 – 40.00) = Rs.187.50 lakhs (including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting Rs.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 capitalisation available under paragraph 46 of AS 11. However, if the company opts to avail the benefit given in paragraph 46A, then nothing is required to be done since the company has done the correct treatment.

Illustration 9

A Ltd. has borrowed USD 10,000 in foreign currency on April 1, 20X1 at 5% p.a. annual interest and acquired a depreciable asset. The exchange rates are as under:

01/04/20X1 1 US$ = Rs.48.00

31/03/20X2 1 US$ = Rs.51.00

You are required to pass the journal entries in the following cases:

(i) Option under Para 46A is not availed.

(ii) Option under Para 46A is availed.

(iii) The loan was taken to finance the operations of the entity (and not to procure a depreciable asset).

In all cases, assume interest accrued on 31 March 20X2 is paid on the same date.

Solution:

Journal Entries in the Books of A Ltd.

(i) Option under Para 46A is not availed

Date	Particulars	Rs.(Dr.)	Rs.(Cr.)
20X1 Apr. 01	Bank Account (10,000 x 48) Dr.	4,80,000	
	To Foreign Loan Account		4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x Rs.51)	25,500	
	To Bank Account		25,500
Mar 31	Foreign Exchange Difference Account (P/L) Dr.	30,000	
	To Foreign Loan Account [10,000 x (51-48)]		30,000

In this case, since the option under Para 46A is **NOT** availed, the Exchange Loss of Rs.30,000 is recognised as an expense in the Statement of Profit and Loss for the year ending 31 March 20X2.

(ii) Option under Para 46A is availed

Date	Particulars	Rs.(Dr.)	Rs.(Cr.)
20X1			
Apr. 01	Bank Account (10,000 x 48) Dr.	4,80,000	
Mar 31	To Foreign Loan Account		4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x Rs.51)	25,500	
Mar 31	To Bank Account		25,500
	Foreign Exchange Difference Account Dr.	30,000	
	To Foreign Loan Account [10,000 x (51-48)]		30,000

	Property, Plant and Equipment Dr. To Foreign Exchange Difference Account	30,000	 30,000

In this case, since the option under Para 46A is availed, the Exchange Loss of Rs.30,000 is capitalized in the cost of Property, Plant and Equipment, which will indirectly get recognized in the Profit & Loss A/c by way of increased depreciation over the remaining useful life of the asset.

(iii) Option under Para 46A is availed

Date	Particulars		Rs.(Dr.)	Rs.(Cr.)
20X1				
Apr. 01	Bank Account (10,000 x 48)	Dr.	4,80,000	
	To Foreign Loan Account			4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x Rs.51)		25,500	
	To Bank Account			25,500
Mar 31	Foreign Exchange Difference Account	Dr.	30,000	
	To Foreign Loan Account [10,000 x (51-48)]			30,000
Mar 31	Foreign Currency Monetary Item Translation Difference A/c (FCMITDA)	Dr.	30,000	
	To Foreign Exchange Difference Account			30,000

In this case, since the option under Para 46A is availed, the Exchange Loss of Rs.30,000 is accumulated in the FCMITD A/c, which will be subsequently spread over and debited to P&L A/c over the tenure of the loan.

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Test Your Knowledge

1. **As per AS 11 assets and liabilities of non-integral foreign operations should be converted at rate.**
   (a) Opening
   (b) Average
   (c) Closing
   (d) Transaction

2. **The debit or credit balance of "Foreign Currency Monetary Item Translation Difference Account"**
   (a) Is shown as "Miscellaneous Expenditure" in the Balance Sheet
   (b) Is shown under "Reserves and Surplus" as a separate line item
   (c) Is shown as "Other Non-current" in the Balance Sheet
   (d) Is shown as "Current Assets" in the Balance Sheet

3. **If asset of an integral foreign operation is carried at cost, cost and depreciation of tangible fixed asset is translated at**
   (a) Average exchange rate
   (b) Closing exchange rate
   (c) Exchange rate at the date of purchase of asset
   (d) Opening exchange rate

4. **Which of the following can be classified as an integral foreign operation?**
   (a) Branch office serving as an extension of the head office in terms of operations
   (b) Independent subsidiary of the parent company
   (c) Branch office independent of the head office in terms of operational decisions
   (d) None of the above

5. **Which of the following items should be converted to closing rate for the purposes of financial reporting?**
   (a) Items of Property, Plant and Equipment
   (b) Inventory
   (c) Trade Payables, Trade Receivables and Foreign Currency Borrowings
   (d) All of the above

Answer to the Multiple Choice Questions

1.	(c)	2.	(b)	3.	(c)	4.	(a)	5.	(c)

Theoretical Questions

6. Explain "monetary item" as per Accounting Standard 11. How are foreign currency monetary items to be recognized at each Balance Sheet date?

Answer:

As per AS 11 'The Effects of Changes in Foreign Exchange Rates', Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Foreign currency monetary items should be reported using the closing rate at each balance sheet date. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realized from, or required to disburse, a foreign currency monetary item 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 realized from or required to disburse, such item at the balance sheet date.

7. Distinguish Non - Integral Foreign Operation (NFO) with Integral Foreign Operation (IFO) as per AS 11.

Answer:

As per AS 11, Integral foreign operation (IFO) 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. In contrast, a non-integral foreign operation (NFO) is a foreign operation that is not an integral operation. For details, refer para 2.5 of chapter.

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Scenario Based Questions

8. Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3. 20X1.

Trade receivables include amount receivable from Umesh Rs.5,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $ 1= Rs.58.50.

Long term loan taken from a U.S. Company, amounting to Rs.60,00,000. It was recorded at US $ 1 = Rs.55.60, taking exchange rate prevailing at the date of transaction. US $ 1 = Rs.61.20 was on 31.3. 20X1.

Answer:

As per AS 11 "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 recognised as income or as expenses in the period in which they arise.

However, at the option of an entity, 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 should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortised over the balance period of such long-term asset/ liability, by recognition as income or expense in each of such periods.

Trade receivables	Foreign Currency Rate	Rs.
Initial recognition US $8,547 (5,00,000/58.50)	1 US $ = Rs.58.50	5,00,000
Rate on Balance sheet date	1 US $ = Rs.61.20	
Exchange Difference Gain US $ 8,547 X (61.20-58.50)		23,077
Treatment: Credit Profit and Loss A/c by Rs.23,077		
Long term Loan		
Initial recognition US $ 1,07,913.67 (60,00,000/55.60)	1 US $ = Rs.55.60	60,00,000
Rate on Balance sheet date	1 US $ = Rs.61.20	
Exchange Difference Loss US $ 1,07,913.67 X (61.20 – 55.60)		6,04,317
Treatment: Credit Loan A/c		
And Debit FCMITD A/C or Profit and Loss		
A/c by Rs.6,04,317		

Thus Exchange Difference on Long term loan amounting Rs.6,04,317 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on debtors amounting Rs.23,077 is required to be transferred to Profit and Loss A/c.

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2022, when the exchange rate was ₹ 43 per US Dollar. The company had recorded the transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2022 when the exchange rate was ₹ 47 per US Dollar. However, on 31st March, 2022, the rate of exchange was ₹ 48 per US Dollar. The company passed an entry on 31st March, 2022 adjusting the cost of raw materials consumed for the difference between ₹ 47 and ₹ 43 per US Dollar.

In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss (RTP Nov'22)

Answer:

As per AS 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', monetary items denominated in a foreign currency should be reported using the closing rate at each balance sheet date. The effect of exchange difference should be taken into profit and loss account. Trade payables is a monetary item, hence should be valued at the closing rate i.e, ₹ 48 at 31st March, 2022 irrespective of the payment for the same subsequently at lower rate in the next financial year. The difference of ₹ 5 (₹ 48–₹ 43) per US dollar should be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2022 and is not to be adjusted against the cost of raw materials. In the subsequent year, the company would record an exchange gain of ₹ 1 per US dollar, i.e., the difference between ₹ 48 and ₹ 47 per US dollar. Hence, the accounting treatment adopted by the company is incorrect.

Question 2:

Trower Limited is an Indian importer. It imports goods from True View Limited situated at London. Trower Limited has a payable of £50,000 to True View Limited as on 31st March, 2023. True View Limited has given Trower Limited the following two options:

(i) Pay immediately with a cash discount of 1% on the payable.

(ii) Pay after 6 months with interest @ 5% p.a. on the payable. The borrowing rate for Trower Limited in rupees is 15% p.a. The following are the exchange rates:

Date	₹
31st March,2023	97
30th September, 2023	99

You are required to give your opinion to Trower Limited on which of the above two options to be chosen. (PYP May '23)

Answer:

Option

(i) Pay immediately with Cash discount of 1% on the payable

	₹
Total amount payable as on 31.3.2023 (50,000 x ₹ 97)	48,50,000
Less: Cash discount	(48,500)
	48,01,500
Add: Borrowing cost @ 15% p.a. for 6 months	3,60,112
If payment made immediate	51,61,612

Option

(ii) Pay after 6 months with interest @ 5% p.a. on the payable

	₹
Total amount payable as on 31.3.2023 (50,000 x ₹ 99)	49,50,000
Interest for 6 months @ 5%	1,23,750
If payment made after 6 months	50,73,750

Thus, Option

(iii) is beneficial to Trower Limited as the Rupee outflow will be lower by ₹ (51,61,612 – 50,73,750) = ₹ 87,862 in option (ii).

Note: The above answer be presented in the alternative manner given as below: Option (i) Pay immediately with Cash discount of 1% on the payable

Total amount payable on 31.3.2023	50,000
Less: Cash discount (50,000 x 1 / 100)	(500)
	49,500
	48,01,500
49,500 x ₹ 97	3,60,112
Add: Borrowing cost @ 15% p.a. for 6 months If payment made immediate	₹ 51,61,612

Option (ii)

Pay after 6 months with interest @ 5% p.a. on the payable

	₹
Total amount payable on 31.3.2023	50,000
Interest for 6 months @ 5% (50,000 x 5 / 100 x 6 / 12)	1.250
	51,250
If payment made after 6 months (51,250 x 99)	50,73,750

Thus, Option (ii) is beneficial to Trower Limited as the Rupee outflow will be lower by ₹ (51,61,612 – 50,73,750) = ₹ 87,862 in option (ii).

AS – 12: Accounting for Government Grants

Illustrations

Illustration 1

Z Ltd. purchased a fixed asset for Rs.50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs.5,00,000. On purchase of the assets government granted it a grant for Rs.10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant amount is deducted from the value of fixed asset.

Solution:

Journal in the books of Z Ltd.

Year	Particulars		Rs.(Dr.)	Rs.(Cr.)
1st	Fixed Assets Account	Dr.	50,00,000	
	To Bank Account			50,00,000
	(Being Fixed Assets purchased)			
	Bank Account	Dr.	10,00,000	
	To Fixed Assets Account			10,00,000
	(Being grant received from the government)			
2nd	Depreciation Account	Dr.	7,00,000	
	To Fixed Assets Account			7,00,000
	(Being Depreciation charged on SLM)			
	Profit & Loss Account	Dr.	7,00,000	
	To Depreciation Account			7,00,000
	(Being Depreciation transferred to P&L Account)			
	Depreciation Account	Dr.	7,00,000	
	To Fixed Assets Account			7,00,000
	(Being Depreciation charged on SLM)			
	Profit & Loss Account	Dr.	7,00,000	
	To Depreciation Account			7,00,000
	(Being Depreciation transferred to P&L Account)			

Illustration 2

Z Ltd. purchased a fixed asset for Rs.50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs.5,00,000. On purchase of the assets government granted it a grant for Rs.10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant is treated as deferred income.

Solution:

Journal in the books of Z Ltd.

Year	Particulars		Rs.(Dr.)	Rs.(Cr.)
1st	Fixed Assets Account	Dr.	50,00,000	
	To Bank Account			50,00,000
	(Being fixed assets purchased)			
	Bank Account	Dr.	10,00,000	
	To Deferred Government Grant Account			10,00,000
	(Being grant received from the government)			

	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being depreciation transferred to P/L Account)			
	Deferred Government Grants Account	Dr.	2,00,000	
	To Profit & Loss Account			2,00,000
	(Being proportionate government grant taken to P/L			
2nd	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being depreciation transferred to P/L Account)			
	Deferred Government Grant Account	Dr.	2,00,000	
	To Profit & Loss Account			2,00,000
	(Being proportionate government grant taken to P/L			

Illustration 3

Santosh Ltd. has received a grant of Rs.8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed Rs.2 crores as dividend. Also, Santosh Ltd. received land free of cost from the State Government but it has not recorded it at all in the books as no money has been spent. In the light of AS 12 examine, whether the treatment of both the grants is correct.

Solution:

As per AS 12 'Accounting for Government Grants', when government grant is received for a specific purpose, it should be utilised for the same. So the grant received for setting up a factory is not available for distribution of dividend.

In the second case, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value. The treatment of both the elements of the grant is incorrect as per AS 12.

Illustration 4

X Ltd. runs a charitable hospital. It incurs salary of doctors, staff etc to the extent of Rs.30 lakhs per annum. As a support, the local Government grants a lumpsum payment of Rs.90 lakhs to meet the salary expense for a period of next 5 years.

You are required to pass the necessary journal entries in the books of the company for first year of the grant and present in the statement of profit & loss when the grant is:

(a) Shown separately as Other Income; and

(b) Deducted against the Salary costs.

Solution:

Journal Entries

Particulars		Rs.(Dr.)	Rs.(Cr.)
Bank Account	Dr.	90,00,000	

To Deferred Income Account			90,00,000
(Being receipt of grant from government)			
Salary Expense Account	Dr.	30,00,000	
To Bank Account			30,00,000
(Being Salary expense paid for the year)			
Deferred Income Account	Dr.	18,00,000	
To Profit & loss Account			18,00,000
(Being Year 1 Grant income recognised in Profit & Loss)			

Note: The grant has been spread on a straight-line basis over a period of 5 years [Rs.90,00,000/5 years = Rs. 18,00,000].

Statement of Profit & Loss Account (Extract)

(a) Shown separately as Other Income:

Particulars	Notes	(Rs.)
Other Income		18,00,000

(b) Deducted against the Salary costs:

Particulars		(Rs.)
Salary cost	30,00,000	
Less: Deferred Government Grant	(18,00,000)	12,00,000

Illustration 5

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, for which no repayment was ordinarily expected. Moreover, there was no condition that the company should purchase any specified assets for this subsidy. Having fulfilled all the conditions under the scheme, the company on its investment of Rs.50 crore in capital assets received Rs.10 crore from the Government in January, 20X2 (accounting period being 20X1-20X2). 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, 20X2. 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 desired by the company is not proper.

Illustration 6

How would you treat the following in the accounts in accordance with AS 12 'Government Grants'?

(i) Rs.35 Lakhs received from the Local Authority for providing medical facilities to the employees.

(ii) Rs.100 Lakhs received as Subsidy from the Central Government for setting up a unit in notified backward area. This subsidy is in nature of nature of promoters' contribution.

Solution:

(i) Rs.35 lakhs received from the local authority for providing medical facilities to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, Rs.35 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

(ii) As per AS 12 'Accounting for Government Grants', where the government grants are in 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 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 from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of Rs.100 lakhs should be credited to capital reserve.

Illustration 7

Z Ltd. purchased a fixed asset for Rs.50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs.5,00,000. On purchase of the assets government granted it a grant for Rs.10 lakhs (This amount was reduced from the cost of fixed asset). Grant was considered as refundable in the end of 2nd year to the extent of Rs.7,00,000. Pass the journal entry for refund of the grant as per the first method.

Solution:

Fixed Assets Account	Dr.	Rs.7,00,000	
To Bank Account			Rs.7,00,000

(Being government grant on asset refunded)

Illustration 8

A fixed asset is purchased for Rs.20 lakhs. Government grant received towards it is Rs.8 lakhs. Residual Value is Rs.4 lakhs and useful life is 4 years. Assume depreciation on the basis of Straight Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of Rs.5 lakhs due to non- compliance with certain conditions. Pass journal entries for first two years.

Solution:

Journal Entries

Year	Particulars		Rs.in lakhs (Dr.)	Rs.in lakhs (Cr.)
1	Fixed Asset Account	Dr.	20	
	To Bank Account			20
	(Being fixed asset purchased)			

	Bank Account To Fixed Asset Account (Being grant received from the government reduced the cost of fixed asset)	Dr.	8	8
	Depreciation Account (W.N.1) To Fixed Asset Account (Being depreciation charged on Straight Line method (SLM))	Dr.	2	2
	Profit & Loss Account To Depreciation Account (Being depreciation transferred to Profit and Loss Account at the end of year 1)	Dr.	2	2
2	Fixed Asset Account To Bank Account (Being government grant on asset partly refunded which increased the cost of fixed asset)	Dr.	5	5
	Depreciation Account (W.N.2) To Fixed Asset Account (Being depreciation charged on SLM on revised value of fixed asset prospectively)	Dr.	3.67	3.67
	Profit & Loss Account To Depreciation Account (Being depreciation transferred to Profit and Loss Account at the end of year 2)	Dr.	3.67	3.67

Working Notes:

1. **Depreciation for Year 1**

	Rs.in lakhs
Cost of the Asset	20
Less: Government grant received	(8)
	12
Depreciation $\left[\frac{12 - 4}{4}\right]$	2

2. **Depreciation for Year 2**

	Rs.in lakhs
Cost of the Asset	20
Less: Government grant received	(8)
	12
Less: Depreciation for the first year $\left[\frac{12 - 4}{4}\right]$	2
	10
Add: Government grant refundable	5
	15
Less: Depreciation for the first year $\left[\frac{15 - 4}{3}\right]$	3.67

Illustration 9

On 1.4.20X1, ABC Ltd. received Government grant of Rs.300 lakhs for acquisition of machinery costing Rs.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 20X4 due to non-fulfillment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd. assuming that the company did not charge any depreciation for year 20X4?

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.

		(Rs.in lakhs)
1st April, 20X1	Acquisition cost of machinery (Rs.1,500 – Rs.300)	1,200.00
31st March, 20X2	Less: Depreciation @ 20%	(240.00)
	Book value	960.00
31st March, 20X3	Less: Depreciation @ 20%	(192.00)
	Book value	768.00
31st March, 20X4	Less: Depreciation @ 20%	(153.60)
1st April, 20X4	Book value	614.40
May, 20X4	Add: Refund of grant	300.00
	Revised book value	914.40

Depreciation @ 20% on the revised book value amounting Rs.914.40 lakhs is to be provided prospectively over the residual useful life of the asset.

Illustration 10

A Ltd. purchased a machinery for Rs.40 lakhs. (Useful life 4 years and residual value Rs.8 lakhs) Government grant received is Rs.16 lakhs.

Show the Journal Entry to be passed at the time of refund of grant in the third year and the value of the fixed assets, if:

(1) the grant is credited to Fixed Assets A/c.

(2) the grant is credited to Deferred Grant A/c.

Solution:

In the books of A Ltd.

Journal Entries (at the time of refund of grant)

(1) If the grant is credited to Fixed Assets Account:

			Rs.	Rs.
I.	Fixed Assets A/c	Dr.	16 lakhs	
	To Bank A/c			16 lakhs
	(Being grant refunded)			

II. The balance of fixed assets after two years depreciation will be Rs.16 lakhs (W.N.1) and after refund of grant it will become (Rs.16 lakhs + Rs.16 lakhs) = Rs.32 lakhs on which depreciation will be charged for remaining two years. Depreciation = (32-8)/2 = Rs.12 lakhs p.a. will be charged for next two years.

(2) If the grant is credited to Deferred Grant Account:

As per para 14 of AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged.

Accordingly, in the first two years (Rs.16 lakhs /4 years) = Rs.4 lakhs p.a. x 2 years = Rs.8 lakhs were credited to Profit and Loss Account and Rs.8 lakhs was the balance of Deferred Grant Account after two years.

Therefore, on refund in the 3rd year, following entry will be passed:

			Rs.	Rs.
I.	Deferred Grant A/c	Dr.	8 lakhs	
	Profit & Loss A/c	Dr.	8 lakhs	
	To Bank A/c			16 lakhs
	(Being Government grant refunded)			

II. Deferred grant account will become Nil. The fixed assets will continue to be shown in the books at Rs.24 lakhs (W.N.2) and depreciation will continue to be charged at Rs.8 lakhs per annum for the remaining two years.

Working Notes:

1. **Balance of Fixed Assets after two years but before refund (under first alternative)**
   Fixed assets initially recorded in the books = Rs.40 lakhs – Rs.16 lakhs
   = Rs.24 lakhs
   Depreciation p.a. = (Rs.24 lakhs – Rs.8 lakhs)/4 years = Rs.4 lakhs per year
   Value of fixed assets after two years but before refund of grant
   = Rs.24 lakhs – (Rs.4 lakhs x 2 years) = Rs.16 lakhs
2. **Balance of Fixed Assets after two years but before refund (under second alternative)**
   Fixed assets initially recorded in the books = Rs.40 lakhs
   Depreciation p.a. = (Rs.40 lakhs – Rs.8 lakhs)/4 years = Rs.8 lakhs per year Book value of fixed assets after two years = Rs.40 lakhs – (Rs.8 lakhs x 2 years)
   = Rs.24 lakhs

Note: Value of fixed assets given above is after refund of government grant.

Illustration 11

Co X runs a charitable hospital. It incurs salary of doctors, staff etc to the extent of Rs.30 lakhs per annum. As a support, the local govt grants a lumpsum payment of Rs.90 lakhs to meet the salary expense for a period of next 5 years.

At the start of Year 4, Co X is unable to meet the conditions attached to the grant and is required to refund the entire grant of 90 lakhs.

You are required to pass the necessary journal entries in the books of the company for refund of the grant if the grant was shown separately as Other Income.

Solution:

			Rs.	Rs.
	Deferred Grant A/c	Dr.	36 lakhs	
	Profit & Loss A/c	Dr.	54 lakhs	
	To Bank A/c			90 lakhs
	(Being Government grant refunded)			

Workings:

Total grant received: Rs.90 Lakhs Grant recognised as income for first 3 years:

Rs.18 lakhs × 3 = Rs.54 lakhs

Remaining Deferred Income

= Rs.90 Lakhs – 54 lakhs = Rs.36 lakhs

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Test Your Knowledge

1. **To encourage industrial promotion, IDCI offers subsidy worth Rs.50 lakhs to all new industries set up in the specified industrial areas. This grant is in the nature of promoter's contribution. How such subsidy should be accounted in the books?**
   (a) Credit it to capital reserve
   (b) Credit it as 'other income' in the profit and loss account in the year of commencement of commercial operations
   (c) Both (a) and (b) are permitted
   (d) Credit it to general reserve

2. **Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be**
   (a) recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable as an ordinary item.
   (b) recognised and disclosed in the Statement of Profit and Loss of the period in which the losses or expenses were incurred.
   (c) recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item if appropriate as per AS 5.
   (d) disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item

3. **Which of the following is an acceptable method of accounting presentation for a government grant relating to an asset?**
   (a) Credit the grant immediately to Income statement
   (b) Show the grant as part of Capital Reserve
   (c) Reduce the grant from the cost of the asset or show it separately as a deferred income on the Liability side of the Balance Sheet.
   (d) Show the grant as part of general Reserve

4. **X Ltd. has received a grant of Rs.20 crore for purchase of a qualified machine costing Rs.80 crore. X Ltd has a policy to recognise the grant as a deduction from the cost of the asset. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of annual depreciation to be charged as an expense in Profit and Loss Statement will be:**
   (a) Rs.10 crore
   (b) Rs.6 crore
   (c) Rs.2 crore
   (d) Rs.8 crore

5. **X Ltd has received a grant of Rs.20 crore for purchase of a qualified machine costing Rs.80 crore. X Ltd. has a policy to recognise the grant as deferred income. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of other income to be to be recognised in Profit and Loss Statement will be:**
   (a) Rs.10 crore
   (b) Rs.6 crore
   (c) Rs.2 crore
   (d) Rs.8 crore

Answer to the Multiple Choice Questions

1.	(a)	2.	(c)	3.	(c)	4.	(b)	5.	(c)

Theoretical Questions

6. AS 12 deals with recognition and measurement of government grants. Please elaborate the parameters which are required to be met before an entity can recognise government grants in its books?

Answer:

A government grant is recognised when 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.

Scenario Based Questions

7. Supriya Ltd. received a grant of Rs.2,500 lakhs during the accounting year 20X1- 20X2 from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilisation. However, during the year 20X2 - 20X3, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full.
Elucidate the current accounting treatment, with reference to the provisions of AS 12

Answer:

As per AS 12 'Accounting for Government Grants', Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item as per 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.

In the present case, the amount of refund of government grant should be first adjusted against the unamortised deferred income in the books and the excess if any will be debited to profit & loss account of the company as an extraordinary item in the year 20X2-20X3.

8. Hygiene Ltd. had received a grant of Rs.50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2024. The company debited the said amount to its machinery account in 2024 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2024 to incorporate the retrospective impact of the same. State whether the treatment done by the company is correct or not.

Answer:

As per the facts of the case, Hygiene Ltd. had received a grant of Rs.50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "Accounting for Government Grants", requires that 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. The Standard further makes it clear that in the first alternative, i.e., 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. Accordingly, the accounting treatment given by Hygiene Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of AS 12.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: Viva Ltd. received a specific grant of ₹ 30 lakhs for acquiring the plant of ₹ 150 lakhs during 2018-19 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet and was not deducted from the cost of plant. During 2021-22, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the Government. Balance in the deferred income on that date was ₹ 21 lakhs and written down value of plant was ₹ 105 lakhs. 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 2021-22 in profit and loss account? (MTP Sep '22)

Answer:

As per AS–12, 'Accounting for Government Grants', "the amount refundable in respect of a grant related to specific fixed asset should be recorded by reducing the deferred income balance. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

In this case the grant refunded is ₹ 30 lakhs and balance in deferred income is ₹ 21 lakhs, ₹ 9 lakhs shall be charged to the profit and loss account for the year 2021–22. There will be no effect on the cost of the fixed asset and depreciation charged will be on the same basis as charged in the earlier years.

Question 2: D Ltd. acquired a machine on 01-04-2017 for ₹ 20,00,000. The useful life is 5 years. The company had applied on 01-04-2017, for a subsidy to the tune of 80% of the cost. The sanction letter for subsidy was received in November 2020. The Company's Fixed Assets Account for the financial year 2020-21 shows a credit balance as under:

Particulars	₹
Machine (Original Cost)	20,00,000
Less: Accumulated Depreciation (from 2017-18- to 2019-20 on Straight Line Method)	12,00,000
	8,00,000
Less: Grant received	(16,00,000)
Balance	(8,00,000)

You are required to explain how should the company deal with this asset in its accounts for 2020-21? (MTP March '23)

Answer:

From the above account, it is inferred that the Company has deducted grant from the book value of asset for accounting of Government Grants; Accordingly, out of the ₹ 16,00,000 that has been received, ₹ 8,00,000 (being the balance in Machinery A/c) should be credited to the machinery A/c; The balance ₹ 8,00,000 may be credited to P&L A/c, since already the cost of the asset to the tune of ₹ 12,00,000 had been debited to P&L A/c in the earlier years by way of depreciation charge, and ₹ 8,00,000 transferred to P&L A/c now would be partial recovery of that cost.

There is no need to provide depreciation for 2020–21 or 2021–22 as the depreciable amount is now Nil.

Question 3:

Samrat Limited has set up its business in a designated backward area which entitles the company for subsidy of 25% of the total investment from Government of India. The company has invested Rs.80 crores in the eligible investments. The company is eligible for the subsidy and has received Rs.20 crores from the government in February 2019. The company wants to recognize the said

subsidy as its income to improve the bottom line of the company. Do you approve the action of the company in accordance with the Accounting Standard? (RTP Nov'22)

Answer:

As per AS 12 "Accounting for Government Grants", where the government grants are in 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. The subsidy received by Samrat Ltd. for setting up its business in a designated backward area will be treated as grant by the government in the nature of promoter's contribution as the grant is given with reference to the total investment in an undertaking i.e. subsidy is 25% of the eligible investment and also no repayment is apparently expected in respect thereof. US $ 8,547 = 5,00,000/58.50 Since the subsidy received is neither in relation to specific fixed assets nor in relation to revenue. Thus, the company cannot recognize the said subsidy as income in its financial statements in the given case. It should be recognized as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Question 4:

Answer the following Questions:

Suraj Limited provides you the following information:

(i) It received a Government Grant @40% towards the acquisition of Machinery worth ₹ 25 Crores.

(ii) It received a Capital Subsidy of ₹ 150 Lakhs from Government for setting up a Plant costing ₹ 300 Lakhs in a notified backward region.

(iii) It received ₹ 50 Lakhs from Government for setting up a project for supply of arsenic free water in a notified area.

(iv) It received ₹ 5 Lakhs from the Local Authority for providing Corona Vaccine free of charge to its employees and their families.

(v) It also received a performance award of ₹ 500 Lakhs from Government with a condition of major renovation in the Power Plant within 3 years. Suraj Limited incurred 90% of amount towards Capital expenditure and balance for Revenue Expenditure.

State, how you will treat the above in the books of Suraj Limited. (PYP May'22)

Answer:

(i) As per AS 12 "Accounting for Govt; Grants", two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under the first alternative, the grant of ₹ 10 crores (40% of 25 crores) is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognized the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Under second alternative method, grant amounting ₹ 10 crores is treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(ii) In the given case, the grant amounting ₹ 150 lakhs received from the Central Government for setting up a plant in notified backward area may be considered as in the nature of promoters' contribution; Thus, amount of ₹ 150 lakhs should be credited to capital reserve and the plant will be shown at ₹ 300 lakhs;

(iii) ₹ 50 lakhs received from Govt. for setting up a project for supply of arsenic free water in notified area should be credited to capital reserve.

Alternatively, if it is assumed that the project consists of capital asset only, then the amount of ₹ 50 lakhs received from Govt; for setting up a project for supply of arsenic free water should either be deducted from cost of asset of the project concerned in the balance sheet or treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(iv) ₹ 5 lakhs received from the local authority for providing corona vaccine to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss account, either separately or under a general heading 'Other Income'; Alternatively, ₹ 5 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

(v) ₹ 500 Lakhs will be reduced from the renovation cost of power plant or will be treated as deferred income irrespective of the expenditure done by the entity out of it as it was specifically received for the purpose major renovation of power plant. However, it may be, later on, decided by the Govt. whether the grant will have to be refunded or not due to non-compliance of conditions attached to the grant.

Question 5:

On 1stApril 2023, Eleanor Limited purchased a manufacturing Plant for ₹ 60 lakhs, which has an estimated useful life of 10 years with a salvage value of ₹ 10 lakhs. On purchase of the Plant, a grant of ₹ 20 lakhs was received from the government.

You are required to calculate the amount of depreciation as per AS 12 for the financial year 2024-25 in the following cases:

(i) If the grant amount is deducted from the value of Plant.

(ii) If the grant is treated as deferred income.

(iii) If the grant amount is deducted from the value of Plant, but at the end of the year 2024-2025 grant is refunded to the extent of ₹ 4 lakhs, due to non-compliance of certain conditions.

(iv) If the grant is treated as the promoter's contribution.

(Assume depreciation on the basis of Straight-Line Method.) **(MTP Sept 25 S2 7M)**

Answer:

Calculation of depreciation as per AS 12 for the financial year 2024-25:

(i) If the grant amount is deducted from the value of Plant, then the amount of deprecation will be ₹ 3,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) / 10 year.

(ii) If the grant is treated as deferred income, then amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000) / 10 year.

(iii) If the grant amount is deducted from the value of plant, but at the end of the year 2024-25 grant is refunded to the extent of ₹ 4 lakh then the amount of depreciation will be ₹ 3,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) /10 year for year 2023-24 and for the year 2024-25 Depreciation will be ₹ 3,00,000 calculated as follows, (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000 – ₹ 3,00,000) / 9 years.

Note: It is assumed that the depreciation for the year has been charged on the book value on the plant before making adjustment for grant. Alternatively, if it is considered otherwise then the depreciation will be charged after making adjustment for grant. In that case depreciation for the year 2024-25 will be as ₹ 3,44,444 calculated as follows, (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000 + 4,00,000 – ₹ 3,00,000 / 9 years

(iv) If the grant is treated as promoter's contribution, then the amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 -10,00,000) /10 year.

Question 6: Zenith Industries Ltd., a manufacturing company, is expanding its operations and has recently undertaken two major initiatives involving government assistance.

(i) The company received a sum of ₹ 65 lakhs from the local authority to develop medical facilities for its employees at its newly built township near the factory premises.

(ii) Additionally, it received ₹ 82 lakhs as a subsidy from the Central Government for establishing a new production unit in a notified backward area. This subsidy has been classified as one in the nature of promoters' contribution, intended to support the long-term development of the enterprise.

You are required to explain how the above transactions should be accounted for in the books of Zenith Industries Ltd. in accordance with Accounting Standard (AS) 12 "Government Grants".

(RTP Sept 25)

Answer:

(i) In the books of Zenith Industries Ltd ₹ 65 lakhs received from the local authority for providing medical facilities to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, ₹ 65 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

(ii) As per AS 12 'Accounting for Government Grants', where the government grants are in 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 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 from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of ₹ 82 lakhs should be credited to capital reserve.

Question 7: Mediwell Hospitals Ltd., a reputed healthcare company operating a chain of multi-specialty hospitals across India, had acquired 40 units of Doppler Scan Machines from Holiver Inc., USA, at a cost of US$ 1,65,100 per unit at the beginning of the financial year 2022-23. The prevailing exchange rate at that time was ₹ 50 per US$.

The acquisition was partly financed through a government grant amounting to ₹ 5 crores, which was sanctioned specifically for the purchase of these machines under a healthcare modernization scheme.

The grant was sanctioned with a specific condition that, in the event of a change in management or ownership control of the company, the grant must be refunded to the government.

In April 2025, 51% of the company's shareholding was acquired by an overseas investor, thereby resulting in a change in management control.

Consequently, the company became liable to refund the entire government grant.

The expected useful life of each Doppler scan machine is 5 years, and the company follows a Straight Line Method (SLM) of depreciation at 20% per annum. Additionally, Mediwell Hospitals Ltd. incurred the following directly attributable costs:

- **Bank charges: US$ 4,000 (for the import transaction as a whole)**
- **Sea freight: ₹ 7,500 per unit**

You are further informed that the company has not maintained any

Capital Reserve or Deferred Income Account in respect of the government grant received.

You are required to advise the accounting treatment in the books of Mediwell Hospitals Ltd. as a result of the return of the government grant, in the light of the relevant provisions of Accounting Standard (AS) 12 – Accounting for Government Grants.

Answer:

The grant is received towards fixed asset. Capital approach is adopted.

Particulars	₹ in lakhs
Cost of asset (Doppler machines) (1,65,100*40 @ 50)	3,302
Add: Freight and other charges (4,000 @ 50+7,500 x 40)	5
	3,307
Less: Grants received	(500)
Cost as per AS-10	2,807
Less: Depreciation for 3 years(2,807 * 20% * 3)	(1684.2)
Carrying amount as on 1/4/2025	1,123
Add: Grant refunded	500
Revised carrying amount	1,623

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AS – 13: Accounting for Investments

Illustrations

Illustration 1

An unquoted long term investment is carried in the books at a cost of Rs.2 lakhs. The published accounts of the unlisted company received in May, 20 X1 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs.20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31 st March, 20X1?

Solution:

As stated in the question that financial statements for the year ended 31st March, 20X1 are still under preparation – The answer has been given on the assumption that the financial statements are yet to be completed and approved by the Board of Directors.

Also, the fall in value of investments has been considered on account of conditions existing on the balance sheet date.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution should 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. AS 13 (Revised) '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 the above basis, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to Rs.20,000 in the financial statements for the year ended 31st March, 20X1.

Illustration 2

X Ltd. on 1-1-20X1 had made an investment of Rs.600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realisable value of all such investment on 31 -3-20X1 became Rs.200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is not temporary in nature. How will you recognise the reduction in financial statements for the year ended on 31 -3-20X1?

Solution:

X Ltd. invested Rs.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. Rs.300 lakhs and remaining as temporary (current) investment i.e. Rs.300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.20 X1 to 31.3.20X1), AS 13 (Revised) 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 realisable value of all such investments on 31.3.20 X1 became Rs.200 lakhs i.e. Rs.100 lakhs in respect of current investment and Rs.100 lakhs in respect of long term investment.

As per AS 13 (Revised), '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 realisable value i.e. at Rs.100 lakhs. The reduction of Rs.200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

The 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 the long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by Rs.200 lakhs and show the investments at Rs.100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of Rs.200 lakhs in the carrying value of long term investment will also be charged to the Statement of profit and loss.

Illustration 3

ABC Ltd. wants to re-classify its investments in accordance with AS 13 (Revised). Decide and state on the amount of transfer, based on the following information:

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

(2) Another portion of current investments purchased for Rs.15 lakhs, to be reclassified as long term investments. The market value of these investments as on the date of balance sheet was Rs.6.5 lakhs.

(3) Certain long term investments no longer considered for holding purposes, to be reclassified as current investments. The original cost of these was Rs.18 lakhs but had been written down to Rs.12 lakhs to recognise other than temporary decline as per AS 13 (Revised).

(MTP May 24 S2 4M)

Solution:

As per AS 13 (Revised), 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.

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

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

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

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

Illustration 4

M/s Innovative Garments Manufacturing Company Limited invested in the shares of another company on 1st October, 20X3 at a cost of Rs.2,50,000. It also earlier purchased Gold of Rs.4,00,000 and Silver of Rs.2,00,000 on 1st March, 20X1. Market value as on 31st March, 20X4 of above investments are as follows:

	Rs.
Shares	2,25,000
Gold	6,00,000
Silver	3,50,000

How above investments will be shown in the books of accounts of M/s Innovative Garments Manufacturing Company Limited for the year ending 31st March, 20 X4 as per the provisions of Accounting Standard 13 "Accounting for Investments"? (MTP May 24 S1 5M)

Solution:

As per AS 13 (Revised) 'Accounting for Investments', for investment in shares if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (Rs.2,50,000) and market value (Rs.2,25,000) as on 31 March 20X4, i.e., Rs.2,25,000.

If equity shares are acquired with an intention to hold for long term period (more than one year), then should be considered as long-term investment to be shown at cost in the Balance Sheet of the company. However, provision for diminution should be made to recognise a decline, if other than temporary, in the value of the investments.

Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 1st March, 20X1) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31st March, 20X4, i.e., Rs.4,00,000 and Rs.2,00,000 respectively, though their market values have been increased.

Illustration 5

In 20X1, M/s. Wye Ltd. issued 12% fully paid debentures of Rs.100 each, interest being payable half yearly on 30th September and 31st March of every accounting year.

On 1st December, 20X2, M/s. Bull & Bear purchased 10,000 of these debentures at Rs.101 ex-interest price, also paying brokerage @ 1% of ex-interest amount of the purchase. On 1st March, 20X3 the firm sold all these debentures at Rs.103 ex-interest price, again paying brokerage @ 1 % of ex-interest amount. Prepare Investment Account in the books of M/s. Bull & Bear for the period 1st December, 20X2 to 1st March, 20X3.

Solution:

In the books of M/s Bull & Bear Investment Account for the period from 1st December 20X2 to 1st March, 20X3 (Scrip: 12% Debentures of M/s. Wye Ltd.)

Date	Particulars	Nominal Value (Rs.)	Interest	Cost (Rs.)	Date	Particulars	Nominal Value (Rs.)	Interest	Cost (Rs.)
1.12.20X2	To Bank A/c (W.N.1)	10,00,000	20,000	10,20,100	1.03.20X3	By Bank A/c (W.N.2)	10,00,000	50,000	10,19,700
1.3.20X3	To Profit & loss A/c* (b.f.)	-	30,000		1.3.20X3	By Profit & loss A/c (b.f.)			400
		10,00,000	50,000	10,20,100			10,00,000	50,000	10,20,100

* This represents income for M/s. Bull & Bear for the period 1st December, 20X2 to 1st March, 20X3, i.e., interest for three months- 1st December, 20X2 to 28 February, 20X3).

Working Notes:

1. Cost of 12% debentures purchased on 1.12.20X2 Rs.

Cost Value (10,000 x Rs.101) = 10,10,000

Add: Brokerage (1% of Rs.10,10,000)	=	10,100
Total	=	10,20,100

2. Sale proceeds of 12% debentures sold

		Rs.
Sales Price (10,000 x Rs.103)	=	10,30,000
Less: Brokerage (1% of Rs.10,30,000)	=	(10,300)
Total	=	10,19,700

Illustration 6

On 1.4.20X1, Mr. Krishna Murty purchased 1,000 equity shares of Rs.100 each in TELCO Ltd. @ Rs.120 each from a Broker, who charged 2% brokerage. He incurred 50 paise per Rs.100 as cost of shares transfer stamps. On 31.1.20X2, Bonus was declared in the ratio of 1: 2. Before and after the record date of bonus shares, the shares were quoted at Rs.175 per share and Rs.90 per share respectively. On 31.3.20X2, Mr. Krishna Murty sold bonus shares to a Broker, who charged 2% brokerage.

Show the Investment Account in the books of Mr. Krishna Murty, who held the shares as Current assets and closing value of investments shall be made at Cost or Market value whichever is lower.

Solution:

In the books of Mr. Krishna Murty Investment Account for the year ended 31st March, 20X2

(Scrip: Equity Shares of TELCO Ltd.)

Date	Particulars	Nominal Value (Rs.)	Cost (Rs.)	Date	Particulars	Nominal Value (Rs.)	Cost (Rs.)
1.4.20X1	To Bank A/c (W.N.1)	1,00,000	1,23,000	31.3.20X2	By Bank A/c (W.N.2)	50,000	44,100
31.1.20X2	To Bonus shares (W.N.5)	50,000	-	31.3.20X2	By Balance c/d (W.N.4)	1,00,000	82,000
31.3.20X2	To Profit & loss A/c (W.N.3)	-	3,100				
		1,50,000	1,26,100			1,50,000	1,26,100

Working Notes:

1. Cost of equity shares purchased on 1.4.20X1 = (1,000 x Rs.120) + (2% of Rs.1,20,000) + (½% of Rs.1,20,000) = Rs.1,23,000
2. Sale proceeds of equity shares (bonus) sold on 31st March, 20X2= (500 x Rs.90) – (2% of Rs.45,000) = Rs.44,100.
3. Profit on sale of bonus shares on 31st March, 20X2

	=	Sale proceeds – Average cost
Sale proceeds	=	Rs.44,100
Average cost	=	Rs.(1,23,000 /1,50,000) x 50,000 = Rs.41,000
Profit	=	Rs.44,100 – Rs.41,000 = Rs.3,100.

4. Valuation of equity shares on 31st March, 20X2

Cost	=	(Rs.1,23,000/1,50,000) x 1,00,000 = Rs.82,000
Market Value	=	1,000 shares × Rs.90 = Rs.90,000

Closing balance has been valued at Rs.82,000 being lower than the market value.

5. Bonus shares do not have any cost.

Illustration 7

Mr. X purchased 500 equity shares of Rs.100 each in Omega Co. Ltd. for Rs.62,500 inclusive of brokerage and stamp duty. Some years later the company resolved to capitalise its profits and to issue to the holders of equity shares, one equity bonus share for every share held by them. Prior to capitalisation, the shares of Omega Co. Ltd. were quoted at Rs.175 per share. After the capitalisation, the shares were quoted at Rs.92.50 per share. Mr. X. sold the bonus shares and received at Rs.90 per share.

Prepare the Investment Account in X's books on average cost basis.

Solution:

In the books of X Investment Account

[Scrip: Equity shares in Omega Co. Ltd.]

Particulars	Nominal Value Rs.	Cost Rs.	Particulars	Nominal Value Rs.	Cost Rs.
To Cash	50,000	62,500	By Cash - Sale (500 x 90)	50,000	45,000
To Bonus shares (W.N.1)	50,000	-	By Balance c/d (W.N. 3)	50,000	31,250
To P & L A/c (W.N. 2)	-	13,750			
	1,00,000	76,250		1,00,000	76,250
To Balance b/d	50,000	31,250			

Working Notes:

1. Bonus shares do not have any cost.
2. Profit on sale of bonus shares = Sales proceeds – Average cost Sales proceeds = Rs.45,000
   Average cost = 500 / 1,000 x 62,500 = Rs.31,250
   Profit = Rs.45,000 – Rs.31,250 = Rs.13,750.
3. Valuation of Closing Balance of Shares at the end of year The total cost of 1,000 share including bonus is Rs.62,500
   Therefore, cost of 500 shares (carried forward) is 500 / 1,000 x 62,500 = Rs.31,250
   Market price of 500 shares = 92.50 x 500 = Rs.46,250
   Cost being lower than the market price, therefore shares are carried forward at cost.

Illustration 8

On 1st April, 20X1, Rajat has 50,000 equity shares of P Ltd. at a book value of Rs.15 per share (nominal value Rs.10 each). He provides you the further information:

(1) On 20th June, 20X1 he purchased another 10,000 shares of P Ltd. at Rs.16 per share.

(2) On 1st August, 20X1, P Ltd. issued one equity bonus share for every six shares held by the shareholders.

(3) On 31st October, 20X1, the directors of P Ltd. announced a right issue which entitles the holders to subscribe three shares for every seven shares at Rs.15 per share. Shareholders can transfer their rights in full or in part.

Rajat sold 1/3rd of entitlement to Umang for a consideration of Rs.2 per share and subscribed the rest on 5th November, 20X1.

You are required to prepare Investment A/c in the books of Rajat for the year ending 31st March, 20X2. (PYP Sept 24 4M)

Solution:

In the books of Rajat Investment Account (Equity shares in P Ltd.)

Date	Particulars	No. of shares	Amount (Rs.)	Date	Particulars	No. of shares	Amount (Rs.)
1.4.X1	To Balance b/d	50,000	7,50,000	31.3.X2	By Balance c/d	90,000	12,10,000
20.6.X1	To Bank A/c	10,000	1,60,000		(Bal. fig.)		
1.8.X1	To Bonus issue (W.N.1)	10,000	-				
5.11.X1	To Bank A/c (right shares) (W.N.4)	20,000	3,00,000				
		90,000	12,10,000			90,000	12,10,000

Working Notes:

(1) Bonus shares = 50,000 +10,000 / 6 = 10,000 shares

(2) Right shares = 50,000 +10,000 +10,000 / 7 x 3 = 30,000 shares

(3) Sale of rights =30,000 shares× 1/3 × Rs.2= Rs.20,000 to be credited to statement of profit and loss

(4) Rights subscribed = 30,000 shares × 2 / 3 ×Rs.15 = Rs.3,00,000

Illustration 9

On 1.4.20X1, Sundar had 25,000 equity shares of 'X' Ltd. at a book value of Rs.15 per share (Nominal value Rs.10). On 20.6.20X1, he purchased another 5,000 shares of the company at Rs.16 per share. The directors of 'X' Ltd. announced a bonus and rights issue. No dividend was payable on these issues. The terms of the issue are as follows:

Bonus basis 1:6 (Date 16.8.20X1).

Rights basis 3:7 (Date 31.8.20X1) Price Rs.15 per share. Due date for payment 30.9.20X1. Shareholders were entitled to transfer their rights in full or in part. Accordingly, Sundar sold 33.33% of his entitlement to Sekhar for a consideration of Rs.2 per share.

Dividends: Dividends for the year ended 31.3.20X1 at the rate of 20% were declared by X Ltd. and received by Sundar on 31.10.20X1. Dividends for shares acquired by him on 20.6.20X1 are to be adjusted against the cost of purchase.

On 15.11.20X1, Sundar sold 25,000 equity shares at a premium of Rs.5 per share. You are required to prepare in the books of Sundar.

(1) Investment Account

(2) Profit & Loss Account.

For your exercise, assume that the books are closed on 31.12.20X1and shares are valued at average cost.

Solution:

Books of Sundar Investment Account (Scrip: Equity Shares in X Ltd.)

		No.	Amount Rs.			No.	Amount Rs.
1.4.20X1	To Bal b/d	25,000	3,75,000	31.10.20X1	By Bank	—	10,000
20.6.20X1	To Bank	5,000	80,000		(dividend		
16.8.20X1	To Bonus (W.N.1)	5,000	—		on shares acquired on		
30.9.20X1	To Bank	10,000	1,50,000		20/6/20X1)		

	(Rights Shares) (W.N.3)				(W.N.4)		
15.11.20X1	ToProfit (on sale of shares)		44,444	15.11.20X1	By Bank (Sale of shares)	25,000	3,75,000
				31.12.20X1	By Bal. c/d (W.N.6)	20,000	2,64,444
		45,000	6,49,444			45,000	6,49,444

Profit and Loss Account (An extract)

To Balance c/d	1,04,444	By Profit transferred	44,444
		By Sale of rights (W.N.3)	10,000
	—	By Dividend (W.N.4)	50,000
	1,04,444		1,04,444

Working Notes:

(1) Bonus Shares = (25,000+5,000) / 6 = 5,000 shares

(2) Right Shares = (25,000+5,000+5,000) / 7 ×3= 15,000 shares

(3) Right shares renounced = 15,000×1/3 = 5,000 shares

Sale of right shares = 5,000 x 2 = Rs.10,000

Right shares subscribed = 15,000 – 5,000 = 10,000 shares

Amount paid for subscription of right shares = 10,000 x 15 = Rs.1,50,000

(4) Dividend received = 25,000 (shares as on 1st April 20X1) × 10 × 20% = Rs.50,000

Dividend on shares purchased on 20.6.20X1 = 5,000×10×20% = Rs.10,000 is adjusted to Investment A/c

(5) Profit on sale of 25,000 shares

= Sales proceeds – Average cost

Sales proceeds = Rs.3,75,000

Average cost = (3,75,000+80,000+1,50,000 -10,000) / 45,000 ×25,000 = Rs.3,30,556

Profit = Rs.3,75,000– Rs.3,30,556= Rs.44,444.

(6) Cost of shares on 31.12.20X1

(3,75,000+80,000+1,50,000 -10,000) / 45,000 ×20,000 = Rs.2,64,444

Test Your Knowledge

1. **The cost of Right shares is**
   - **(a)** added to the cost of investments.
   - **(b)** subtracted from the cost of investments.
   - **(c)** no treatment is required.
   - **(d)** added to cost of investments at market value.

2. **Long term investments are carried at**
   - **(a)** fair value.
   - **(b)** cost less 'other than temporary' decline.
   - **(c)** Cost and market value whichever is less.
   - **(d)** Cost and market value whichever is higher.

3. **Current investments are carried at**
   - **(a)** Fair value.
   - **(b)** cost.
   - **(c)** Cost and fair value, whichever is less.
   - **(d)** Cost and fair value, whichever is higher.

4. **A Ltd. acquired 2,000 equity shares of Omega Ltd. on cum-right basis at Rs.75 per share. Subsequently, omega Ltd. made a right issue of 1:1 at Rs.60 per share, which was subscribed for by A. Total cost of investments at the year-end will be Rs.**
   - **(a)** 2,70,000.
   - **(b)** 1,50,000.
   - **(c)** 1,20,000.
   - **(d)** 1,70,000.

5. **Cost of investment includes**
   - **(a)** Purchase costs.
   - **(b)** Brokerage and Stamp duty paid.
   - **(c)** Both (a) and (b).
   - **(d)** none of the above.

Answer to the Multiple Choice Questions

1.	(a)	2.	(b)	3.	(c)	4.	(a)	5.	(c)

Theoretical Questions

6. Briefly explain disclosure requirements for Investments as per AS - 13.

Answer:

The disclosure requirements as per AS 13 (Revised) are as follows:

(i) Accounting policies followed for the determination of carrying amount of investments.

(ii) Classification of investment into current and long term.

(iii) The amount included in profit and loss statements for

- **(a)** Interest, dividends and rentals for long term and current investments, disclosing therein gross income and tax deducted at source thereon;
- **(b)** Profits and losses on disposal of current investment and changes in carrying amount of such investments;
- **(c)** Profits and losses and disposal of long term investments and changes in carrying amount of investments.

(iv) Aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;

(v) Any significant restrictions on investments like minimum holding period for sale/disposal, utilisation of sale proceeds or non-remittance of sale proceeds of investment held outside India.

(vi) Other disclosures required by the relevant statute governing the enterprises

7. How will you classify the investments as per AS 13? Explain in Brief.

Answer:

The investments are classified into two categories as per AS 13, viz., Current Investments and Long-term 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 carrying amount for current investments is the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the statement of profit and loss.

A long-term investment is an investment other than a current investment. Long term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long term investment, the carrying amount is reduced to recognise the decline. The reduction in carrying amount is charged to the statement of profit and loss.

8. Whether the accounting treatment 'at cost' under the head 'Long Term Investments' without providing for any diminution in value is correct and in accordance with the provisions of AS 13. If not what should have been the accounting treatment in such a situation? Explain in brief.

Answer:

The accounting treatment 'at cost' under the head 'Long Term Investment' in the financial statements of the company without providing for any diminution in value is correct and is in accordance with the provisions of AS 13 provided that there is no decline, other than temporary, in the value of investment. If the decline in the value of investment is, other than temporary, compared to the time when the shares were purchased, provision is required to be made.

Scenario Based Questions

9. Mr. X acquires 200 shares of a company on cum right basis for Rs.70,000. He subsequently receives an offer of right to acquire fresh shares in the company in the proportion of 1:1 at Rs.107 each. He does not subscribe but sells all the rights for Rs.12,000. The market value of the shares after their becoming ex-rights has also gone down to Rs.60,000. What should be the accounting treatment in this case?

Answer:

As per AS 13, 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. In this case, the amount of the ex-right market value of 200 shares bought by X immediately after the declaration of rights falls to Rs.60,000. In this case, out of sale proceeds of Rs.12,000, Rs.10,000 may be applied to reduce the carrying amount to bring it to the market value and Rs.2,000 would be credited to the profit and loss account.

10. On 1st April, 20X1, XY Ltd. has 15,000 equity shares of ABC Ltd. at a book value of Rs.15 per share (nominal value Rs.10 per share). On 1st June, 20X1, XY Ltd. acquired 5,000 equity shares of ABC Ltd. for Rs.1,00,000. ABC Ltd. announced a bonus and right issue.

(1) Bonus was declared, at the rate of one equity share for every five shares held, on 1st July 20X1.

(2) Right shares are to be issued to the existing shareholders on 1st September 20X1. The company will issue one right share for every 6 shares at 20% premium. No dividend was payable on these shares.

(3) Dividend for the year ended 31.3.20X1 were declared by ABC Ltd. @ 20%, which was received by XY Ltd. on 31st October 20X1.

XY Ltd.

(i) Took up half the right issue.

(ii) Sold the remaining rights for Rs.8 per share.

(iii) Sold half of its shareholdings on 1st January 20X2 at Rs.16.50 per share. Brokerage being 1%.

You are required to prepare Investment account of XY Ltd. for the year ended 31st March 20X2 assuming the shares are being valued at average cost.

Answer:

In the books of XY Ltd.

Investment in equity shares of ABC Ltd.

for the year ended 31st March, 20X2

Date	Particulars	No.	Dividend Rs.	Amount Rs.	Date	Particulars	No.	Dividend Rs.	Amount Rs.
20X1 April 1	To Balance b/d	15,000	-	2,25,000	20X1 Oct. 31	By Bank A/c (W.N. 5)	-	30,000	10,000
June 1	To Bank A/c	5,000	--	1,00,000	20X2 Jan. 1	By Bank A/c (W.N.4)	13,000	-	2,12,355

July 1	To Bonus Issue (W.N. 1)	4,000	-	-	March 31	By Balance c/d (W.N. 6)	13,000	-	1,69,500
Sept.1	To Bank A/c (W.N. 2)	2,000	-	24,000	20X2 Jan 1	To P & L A/c (W.N. 4)	-	-	42,855
"20X2 March 31	To P & L A/c	-	30,000	-					
		26,000	30,000	3,91,855			26,000	30,000	3,91,855

Working Notes:

1. **Calculation of no. of bonus shares issued**

   Bonus Shares = 15,000 shares+5,000 shares / 5 x 1= 4,000 shares

2. **Calculation of right shares subscribed**

   Right Shares = 15,000 shares+5,000 shares+4,000 shares / 6 = 4,000 shares

   Shares subscribed by XY Ltd. = 4,000 / 2 = 2,000 shares

   Value of right shares subscribed = 2,000 shares @ Rs.12 per share

   = Rs.24,000

3. **Calculation of sale of right entitlement**

   2,000 shares x Rs.8 per share = Rs.16,000

   Amount received from sale of rights will be credited to statement of profit and loss.

4. **Calculation of profit on sale of shares**

   Total holding = 15,000 shares original

   5,000 shares purchased

   4,000 shares bonus

   2,000 shares right shares

   26,000 shares

   50% of the holdings were sold

   i.e. 13,000 shares (26,000 x1/2) were sold.

   Cost of total holdings of 26,000 shares (on average basis)

   = Rs.2,25,000 + Rs.1,00,000 + Rs.24,000– Rs.10,000 = Rs.3,39,000

   Average cost of 13,000 shares would be

   = 3,39,000 / 26,000 ×13,000

   = Rs.1,69,500

	Rs.
Sale proceeds of 13,000 shares (13,000 x Rs.16.50)	2,14,500
Less: 1% Brokerage	(2,145)
	2,12,355
Less: Cost of 13,000 shares	(1,69,500)
Profit on sale	42,855

5. **Dividend received on investment held as on 1st April, 20X1**

   = 15,000 shares x Rs.10 x 20%

   = Rs.30,000 will be transferred to Profit and Loss A/c

   Dividend received on shares purchased on 1st June, 20X1

   = 5,000 shares x Rs.10 x 20% = Rs.10,000 will be adjusted to Investment A/c

Note: It is presumed that no dividend is received on bonus shares as bonus shares are declared on 1st July, 20X1 and dividend pertains to the year ended 31.3.20X1.

6. **Calculation of closing value of shares (on average basis) as on 31st March, 20X2**
   13,000× 3,39,000 / 26,000 = Rs.1,69,500

11. The following information is presented by Mr. Z (a stock broker), relating to his holding in 9% Central Government Bonds.
Opening balance (nominal value) Rs.1,20,000,
Cost Rs.1,18,000 (Nominal value of each unit is Rs.100).
1.3.20X1 Purchased 200 units, ex-interest at Rs.98.
1.7.20X1 Sold 500 units, ex-interest out of original holding at Rs.100.
1.10.20X1 Purchased 150 units at Rs.98, cum interest.
1.11.20X1 Sold 300 units, ex-interest at Rs.99 out of original holdings.
Interest dates are 30th September and 31st March. Mr. Z closes his books every 31st December. Show the investment account as it would appear in his books. Mr. Z follows FIFO method.

Answer:

In the Books of Mr. Z

9% Central Government Bonds (Investment) Account

Particulars		Nominal Value	Interest	Principal	Particulars		Nominal Value	Interest	Principal
20X1		Rs	Rs	Rs	.20X1		Rs.	Rs.	Rs.
Jan.1	To Balance b/d (W.N.1)	1,20,000	2,700	1,18,000	Mar. 31	By Bank A/c (W.N.3)	-	6,300	-
March 1	To Bank A/c (W.N.2)	20,000	750	19,600	July 1	By Bank A/c (W.N.4)	50,000	1,125	50,000
July 1	To P&L A/c (W.N.5)	-	-	833	Sept.30	By Bank A/c (W.N.6)	-	4,050	-
Oct. 1	To Bank A/c (150 x 98)	15,000	-	14,700	Nov. 1	By Bank A/c (W.N.7)	30,000	225	29,700
Nov. 1	To P&L A/c (W.N.8)	-	-	200	Dec. 31	By Balance c/d (W.N. 9 & W.N.10)	75,000	1,688	73,633
Dec. 31	To P&L A/c (b.f.) (Transfer)	9,938							
		1,55,000	13,388	1,53,333		1,55,000	13,388	1,53,333	

Working Note:

1. Interest element in opening balance of bonds = 1,20,000 x 9% x 3/12 = Rs.2,700
2. **Purchase of bonds on 1. 3.20X1**
   Interest element in purchase of bonds = 200 x 100 x 9% x 5/12 = Rs.750
   Investment element in purchase of bonds = 200 x 98 = Rs.19,600
3. Interest for half-year ended 31 March = 1,400 x 100 x 9% x 6/12 = Rs.6,300
4. Sale of bonds on 1.7.20X1
   Interest element = 500 x 100 x 9% x 3/12 = Rs.1,125
   Investment element = 500 x 100 = Rs.50,000
5. **Profit on sale of bonds on 1.7.20X1**
   Cost of bonds = (1,18,000/ 1,200) x 500 = Rs.49,167
   Sale proceeds = Rs.50,000

Profit element = Rs.833

6. **Interest for half-year ended 30 September**
   = 900 x 100 x 9% x 6/12 = Rs.4,050
7. **Sale of bonds on 1.11.20X1**
   Interest element = 300 x 100 x 9% x 1/12 = Rs.225
   Investment element = 300 x 99 = Rs.29,700
8. **Profit on sale of bonds on 1.11.20X1**
   Cost of bonds = (1,18,000/ 1,200) x 300 = Rs.29,500
   Sale proceeds = Rs.29,700
   Profit element = Rs.200
9. Closing value of investment

Calculation of closing balance:	**Nominal value**		**Rs.**
Bonds in hand remained in hand at 31st December 20X1			
From original holding (1,20,000 – 50,000 – 30,000) =	40,000	$\frac{1,18,000}{1,20,000} \times 40,000$	39,333
Purchased on 1st March	20,000		19,600
Purchased on 1st October	15,000		14,700
	75,000		73,633

10. Interest element in closing balance of bonds = 750 x 100 x 9% x 3/12 = Rs.1,688

12. Mr. Purohit furnishes the following details relating to his holding in 8% Debentures (Rs.100 each) of P Ltd., held as Current assets:

1.4.20X1 Opening balance – Nominal value Rs.1,20,000, Cost Rs.1,18,000
1.7.20X1 100 Debentures purchased ex-interest at Rs.98
1.10.20X1 Sold 200 Debentures ex-interest at Rs.100
1.1.20X2 Purchased 50 Debentures at Rs.98 ex-interest
1.2.20X2 Sold 200 Debentures ex-interest at Rs.99

Due dates of interest are 30th September and 31st March.
Mr. Purohit closes his books on 31.3.20X2. Brokerage at 1% is to be paid for each transaction (at ex-interest price). Show Investment account as it would appear in his books. Assume FIFO method. Market value of 8% Debentures of P Limited on 31.3.20X2 is Rs.99.

Answer:

Investment A/c of Mr. Purohit
for the year ending on 31-3-20X2
(Scrip: 8% Debentures of P Limited)
(Interest Payable on 30th September and 31st March)

Date	Particulars	Nominal Value	Interest	Cost	Date	Particulars	Nominal Value	Interest	Cost
			Rs.	Rs.				Rs.	Rs.
1.4.20X1	To Balance b/d	1,20,000	-	1,18,000	30.9.20X1	By Bank (1,300 x 100 x 8% x 6/12)	-	5,200	-
1.7.20X1	To Bank (ex-Interest) (W.N.1)	10,000	200	9,898	1.10.20X1	By Bank (W.N.4)	20,000	-	19,800

1.10.20X1	To Profit & Loss A/c (W.N.4)			133	1.2.20X2	By Bank (ex-Interest) (W.N.5)	20,000	533	19,60
1.1.20X2	To Bank (ex-Interest) (W.N.2)	5,000	100	4,949	1.2.20X2	By Profit & Loss A/c (W.N.5)			64
31.3.20X2	To Profit & Loss A/c (Bal. fig.)	-	9,233		31.3.20X2	By Bank (950 x 100 x 8% x 6/12)	-	3,800	-
					31.3.20X2	By Balance c/d (W.N.3)	95,000	-	93,514
		1,35,000	9,533	1,32,980			1,35,000	9,533	1,32,980

Working Notes:

1. **Purchase of debentures on 1.7.20X1**

   Interest element = 100 x 100 x 8% x 3/12 = Rs.200

   Investment element = (100 x 98) + [1% (100 x 98)] = Rs.9,898

2. **Purchase of debentures on 1.1.20X2**

   Interest element = 50 x 100 x 8% x 3/12 = Rs.100

   Investment element = {(50 x 98) + [1%(50 x 98)]} = Rs.4,949

3. **Valuation of closing balance as on 31.3.20X2:**

   Market value of 950 Debentures at Rs.99 = Rs.94,050

   Cost of 800 Debentures cost = $\left[\frac{1,18,000}{1,20,000} \times 80,000\right]$ = 78,667

   100 Debentures cost = 9,898

   50 Debentures cost = 4,949

   93,514

   Value at the end = Rs.93,514, i.e., whichever is less

4. Profit on sale of debentures as on 1.10.20X1

	Rs.
Sales price of debentures (200 x Rs.100)	20,000
Less: Brokerage @ 1%	(200)
	19,800
Less: Cost of Debentures = $\left[\frac{1,18,000}{1,20,000} \times 20,000\right]$	(19,667)
Profit on sale	133

5. **Loss on sale of debentures as on 1.2.20X2**

	Rs.
Sales price of debentures (200 x Rs.99)	19,800
Less: Brokerage @ 1%	(198)
	19,602
Less: Cost of Debentures = $\left[\frac{1,18,000}{1,20,000} \times 20,000\right]$	(19,666)
Loss on sale	64
Interest element in sale of investment = 200 x 100 x 8% x 4/12	Rs.533

13. On 1st April, 20X1, Mr. Vijay had 30,000 Equity shares in X Ltd. at a book value of Rs.4,50,000 (Face Value Rs.10 per share). On 22nd June, 20X1, he purchased another 5000 shares of the same company for Rs.80,000.
The Directors of X Ltd. announced a bonus of equity shares in the ratio of one share for seven shares held on 10th August, 20X1.
On 31st August, 20X1 the Company made a right issue in the ratio of three shares for every eight shares held, on payment of Rs.15 per share. Due date for the payment was 30th September, 20X1, Mr. Vijay subscribed to 2/3rd of the right shares and sold the remaining of his entitlement to Viru for a consideration of Rs.2 per share.
On 31st October, 20X1, Vijay received dividends from X Ltd. @ 20% for the year ended 31st March, 20X1. Dividend for the shares acquired by him on 22nd June, 20X1 to be adjusted against the cost of purchase.
On 15th November, 20X1 Vijay sold 20,000 Equity shares at a premium of Rs.5 per share.
You are required to prepare Investment Account in the books of Mr. Vijay for the year ended 31st March, 20X2 assuming the shares are being valued at average cost.

Answer:

Investment Account in Books of Vijay
(Scrip: Equity Shares in X Ltd.)

		No.	Amount			No.	Amount
			Rs.				Rs.
1.4.20X1 22.6.20X1	To Bal b/d To Bank	30,000 5,000	4,50,000 80,000	31.10.20X1	By Bank (dividend on shares acquired on 22.6.20X1)	—	10,000
10.8.20X1	To Bonus	5,000	—				
30.9.20X1	To Bank (Rights Shares)	10,000	1,50,000	15.11.20X1	By Bank Sale of shares)	20,000	3,00,000
15.11.20X1	To P&L A/c (Profit on sale of shares)		32,000	31.3.20X2	By Bal. c/d	30,000	4,02,000
		50,000	7,12,000			50,000	7,12,000

Working Notes:

(1) Bonus Shares = (30,000 + 5,000) / 7 = 5,000 shares

(2) Right Shares = (30,000 + 5,000 + 5,000) / 8 x 3 = 15,000 shares

(3) Rights shares sold = 15,000×1/3 = 5,000 shares

(4) Dividend received = 30,000×10×20% = Rs.60,000 will be taken to P&L statement

(5) Dividend on shares purchased on 22.6.20X1

= 5,000×10×20%

= Rs.10,000 is adjusted to Investment A/c

(6) Profit on sale of 20,000 shares

= Sales proceeds – Average cost

Sales proceeds = Rs.3,00,000

Average cost = (4,50,000 + 80,000 + 1,50,000 - 10,000) / 50,000 × 20,000 = Rs.2,68,000

Profit = Rs.3,00,000– Rs.2,68,000= Rs.32,000.

(7) Cost of shares on 31.3.20X2

(4,50,000 + 80,000 + 1,50,000 - 10,000) / 50,000 × 30,000 = Rs.4,02,000

(8) Sale of rights amounting Rs.10,000 (Rs.2 x 5,000 shares) will not be shown in investment A/c but will directly be taken to P & L statement.

14. Blue-chip Equity Investments Ltd., wants to re-classify its investments in accordance with AS 13 (Revised). State the values, at which the investments have to be reclassified in the following cases:

(i) Long term investments in Company A, costing Rs.8.5 lakhs are to be re- classified as current. The company had reduced the value of these investments to Rs.6.5 lakhs to recognise 'other than temporary' decline in value. The fair value on date of transfer is Rs.6.8 lakhs.

(ii) Long term investments in Company B, costing Rs.7 lakhs are to be re- classified as current. The fair value on date of transfer is Rs.8 lakhs and book value is Rs.7 lakhs.

(iii) Current investment in Company C, costing Rs.10 lakhs are to be re- classified as long term as the company wants to retain them. The market value on date of transfer is Rs.12 lakhs.

Answer:

As per AS 13 (Revised) 'Accounting for 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. And where investments are reclassified from current to long term, transfers are made at lower of cost and fair value on the date of transfer.

Accordingly, the re-classification will be done on the following basis:

(i) In this case, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at Rs.6.5 lakhs in the books.

(ii) The carrying / book value of the long term investment is same as cost i.e. Rs.7 lakhs. Hence this long term investment will be reclassified as current investment at book value of Rs.7 lakhs only.

(iii) In this case, reclassification of current investment into long-term investments will be made at Rs.10 lakhs as cost is less than its market value of Rs.12 lakhs.

15. Gowtham Limited invested in shares of another company (with the intention to hold the shares for short-term period) on 30th November, 2021 at a cost of Rs.4,25,000. It also earlier purchased Gold of Rs.8,00,000 and Silver of Rs.3,50,000 on 31st March, 20X1.

Market values as on 31st March, 20X4, of the above investments are as follows:

Shares	**Rs.3,50,000**
Gold	**Rs.10,25,000**
Silver	**Rs.5,10,000**

You are required to explain how will the above investments be shown (individually and in total) in the books of account of Gowtham Limited for the year ending 31st March, 20X4 as per the provisions of AS 13.

Answer:

As per AS 13 (Revised) 'Accounting for Investments', for investment in shares - if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (Rs.4,25,000) and market value (Rs.3,50,000) as on 31 March 20X4, i.e.,

Rs.3,50,000.

Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 31stMarch, 20X1) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31st March, 20X4, i.e., Rs.8,00,000 and Rs.3,50,000 respectively, though their market values have been increased.

Thus the shares, gold and silver will be shown at Rs.3,50,000, Rs.8,00,000 and Rs.3,50,000 respectively and hence, total investment will be valued at Rs.15,00,000 for the year ending on 31st March, 20X4 as per AS 13.

SHRESHTA
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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: Whether the accounting treatment 'at cost' under the head 'Long Term Investments' without providing for any diminution in value is correct and in accordance with the provisions of AS 13. If not, what should have been the accounting treatment in such a situation? What methodology should be adopted for ascertaining the provision for diminution in the value of investment, if any. Explain in brief.(MTP Mar 22)

Answer:

The accounting treatment 'at cost' under the head 'Long Term Investment' in the financial statements of the company without providing for any diminution in value is correct and is in accordance with the provisions of AS 13 provided that there is no decline, other than temporary, in the value of investment. If the decline in the value of investment is, other than temporary, compared to the time when the shares were purchased, provision is required to be made. The reduction in market value should not be considered, in isolation to determine the decline, other than temporary.

The amount of the provision for diminution in the value of investment may be ascertained considering the factors indicated in AS 13.

Question 2: How you will deal with following in the financial statements of the Parish Electronics Ltd. as on 31.3.18 with reference to AS-13?

Also Parish Electronics Ltd. has current investment (X Ltd.'s shares) purchased for Rs/ 5 lakhs, which the company want to reclassify as long term investment. The market value of these investments as on date of Balance Sheet was Rs. 2.5 lakhs. [MTP Oct '22)

Answer:

As per AS 13 'Accounting for Investments', where investments are reclassified from current tolong – term, transfers are made at the lower of cost or fair value at the date of transfer.

In the given case, the market value of the investment (X Ltd. shares) is Rs.2.50 lakhs, which is lower than its cost i.e. Rs. 5 lakhs. Therefore, the transfer to long term investments should be made at cost of Rs. 2.50 lakhs. The loss of Rs. 2.50 lakhs should be charged to profit and loss account.

Question 3: Mr. Vijay entered into the following transactions of purchase and sale of equity shares of JP Power Ltd. The shares have paid up value of ₹ 10 per share/

Date	No. of Shares	Terms
01.01.2019	600	Buy @ ₹ 20 per share
15.03.2019	900	Buy @ ₹ 25 per share
20.05.2019	1000	Buy @ ₹ 23 per share
25.07.2019	2500	Bonus Shares received
20.12.2019	1500	Sale @ ₹ 22 per share
01.02.2020	1000	Sale @ ₹ 24 per share

Addition information:

(1) On 15.09.2019 dividend @ ₹ 3 per share was received for the year ended 31.03.2019.

(2) On 12.11.2019 company made a right issue of equity shares in the ratio of one share for five shares held on payment of ₹ 20 per share. He subscribed to 60% of the shares and renounced the remaining shares on receipt of ₹ 3 per share.

(3) Shares are to be valued on weighted average cost basis.

You are required to prepare Investment Account for the year ended 31.03.2019 and 31.03.2020. (MTP Mar'22)

Answer:

(a) (i) Investment in Equity shares of JP Power Ltd.

Date	Particulars	No.	Dividend ₹	Amount ₹	Date	Particulars	No.	Dividend ₹	Amount ₹
1.1.19	To Bank A/c	600		12,000	31.3.19	By Balance c/d	1,500		34,500
15.3.19	To Bank A/c	900		22,500				4,500	
		1,500		34,500			1,500		34,500
1.4.19	To Balance b/d	1,500		34,500	15.9.19	By Bank dividend			3,000
20.5.19	To Bank A/c	1,000		23,000	20.12.19	By Bank	1,500		33,000
25.7.19	To Bonus shares	2,500		_	1.2.20	By Bank	1,000		24,000
12.11.19	To Bank A/c	600	4,500	12,000	31.3.20	By Balance c/d	3,100		36,812.50
20.12.19	To P& L A/c (profit on sale)			15,187.50					
1.2.20	To P& L A/c (profit on sale)			12,125					
31.3.20	To P & L A/c (dividend)								
		5,600	4,500	96,812.50			5,600	4,500	96,812.50

Working Notes:

1. **Calculation of Weighted average cost of equity shares**
   600 shares purchased at ₹ 12,000
   900 shares purchased at ₹ 22,500
   1,000 shares purchased at ₹ 23,000
   2,500 shares at nil cost
   600 right shares purchased at ₹ 12,000
   Total cost of 5,600 shares is ₹ 66,500 [₹ 69,500 less ₹ 3,000 (pre–acquisition dividend received on 1,000 shares purchased on 20.5.19].
   Hence, weighted average cost per share will be considered as ₹ 11;875 per share (66,500/5,600);
2. It has been considered that no dividend was received on bonus shares as the dividend pertains to the year ended 31set March, 2019.
3. **Calculation of right shares subscribed by Vijay Right Shares (considering that right shares have been granted on Bonus shares also) = 5,000/5 x 1= 1,000 shares**
   Shares subscribed = 1,000 x 60%= 600 shares
   Value of right shares subscribed = 600 shares @ ₹ 20 per share = ₹ 12,000
   Calculation of sale of right renouncement
   No. of right shares sold = 1,000 x 40% = 400 shares
   Sale value of right = 400 shares x ₹ 3 per share = ₹ 1,200
   Note: As per para 13 of AS 13, sale proceeds of rights is to be credited to P & L A/c.
4. **Profit on sale of equity shares**
   As on 20.12.19

Sales price	(1,500 shares at ₹ 22) 33,000.00
Less: Cost of shares sold (1,500 x ₹ 11.875)	(17,812.50)
Profit on sale	15,187.50

   As on 1. 2.20

Sales price	(1,000 shares at ₹ 24) 24,000
Less: Cost of shares sold (1,000 x ₹ 11.875)	(11,875)
Profit on sale	12,125

   Balance of 3,100 shares as on 31;3;20 will be valued at ₹ 36,812;50 (at rate of ₹ 11.875 per share)

Question 4: A Ltd. purchased on 1st April, 2022 8% convertible debenture in C Ltd. of face value of ₹ 2,00,000 @ ₹ 108/ On 1st July, 2022 A Ltd. purchased another ₹ 1,00,000 debentures @ ₹ 112 cum interest/ On 1st October, 2022 ₹ 80,000 debentures were sold @ ₹ 105/ On 1st December, 2022, C Ltd. give option for conversion of 8% convertible debentures into equity share of ₹ 10 each/ A Ltd. received 5,000 equity shares in C Ltd. in conversion of 25% debentures held on that date. The market price of debenture and equity share in C Ltd. on 31st December, 2022 is ₹ 110 and ₹ 15 respectively/ Interest on debenture is payable each year on 31 st March, and 30th September. Prepare investment account in the books of A Ltd. on average cost basis for the accounting year ended 31st December, 2022.

(MTPApril 23, April '22, Oct '23, MTP Sep 25 S1 10M)

Answer:

Investment Account for the year ending on 31st December, 2022 Scrip : 8% Convertible Debentures in C Ltd.

[Interest Payable on 31st March and 30th September]

Date	Particulars	Nominal value Rs.	Interest Rs.	Cost Rs.	Date	Particulars	Nominal Value Rs.	interest Rs.	Cost (Rs.)
1.4.22	To Bank A/c	2,00,000	-	2,16,000	30.09.2022	By Bank A/c	-	12,000	
1.7.22	To Bank A/c (W.N.1)	1,00,000	2,000	1,10,000		[7 3,00,000 X 8% x (6/12]			
31.12.22	To P & L A/c		14,033	-	1.10.2022	By Bank A/ c	80,000		84,000
	[Interest]				1.10.2022	By P & LA/c (loss) (W.N.3)			2,933
					1.12.2022	By Bank A/c (Accrued interest) (T 55,000 x 08 x 2/12)		733	
					1.12.2022	By Equity shares in C Ltd. (W.N.3 and 4)	55,000		59,767
					31.12.2022	By Balance c/d (W.N.5)	1,65,000	3,300	1,79,300
		3,00,000	16,033	3,26,000			3,00,000	16,033	3,26,000

SCRIP: Equity Shares in C LTD.

Date	Particulars	Cost (Rs.)	Date	Particulars	Cost (Rs.)
1.12.2022	To 8 % debentures	59,767	31.12.2022	By balance c/d	59,767

Working Notes:

(i) Cost of Debenture purchased on 1st July = Rs. 1,12,000 — Rs. 2,000 (Interest) = Rs. 1,10,000

(ii) Cost of Debentures sold on 1st Oct.

= (Rs.2,16,000 + Rs. 1,10,000) x 80,000/3,00,000

(iii) Loss on sale of Debentures = Rs. 86,933— Rs.84,000 Nominal value of debentures converted into equity shares [(Rs. 3,00,000 — 80,000) x.25]

Interest received before the conversion of debentures Interest on 25% of total debentures =

55,000 x 8% x 2/12 = 733

(iv) Cost of Debentures converted = (Rs. 2,16,000 + Rs. 1,10,000) x 55,000/3,00,000 = Rs. 59,767

(v) Cost of closing balance of Debentures = (Rs. 2,16,000 + Rs.1,10,000) x 1,65,000 / 3,00,000 = Rs. 1,79,300

(vi) Closing balance of Debentures has been valued at cost.

(vii) 5,000 equity Shares in C Ltd. will be valued at cost of Rs. 59,767 being lower than the market value Rs. 75,000 (Rs. 15 x5,000)

Note: It is assumed that interest on debentures, which are converted into cash, has been received at the time of conversion.

Question 5: Gopal holds 2,000, 15% Debentures of ₹ 100 each in Ritu Industries Ltd. as on April 1, 2021 at a cost of ₹ 2,10,000/ Interest is payable on June, 30th and December, 31st each year/ On May 1, 2021, 1,000 debentures are purchased cum-interest at ₹ 1,07,000/ On November 1, 2021, 1,200 debentures are sold ex-interest at ₹ 1,14,600/ On November 30, 2021, 800 debentures are purchased ex-interest at ₹ 76,800. On December 31, 2021, 800 debentures are sold cum-interest for ₹ 1,10,000/ You are required to prepare the Investment Account showing value of holdings on March 31, 2022 at cost, using FIFO Method/

(MTP Oct '22)

Answer:

Investment Account of Gopal For the year ended 31.3.2022

(Script: 15% Debentures in Ritu Industries Ltd.) (Interest payable on 30th June and 31st December)

Date	Particulars	Nominal Value ₹	Interest ₹	Cost ₹	Date	Particulars	Nominal Value ₹	Interest ₹	Cost ₹
1.04.21	To Balance A/c	2,00,000	7,500	2,10,000	30.06.21	By Bank A/c	-	22,500	
1.05.21	To Bank A/c	1,00,000	5,000	1,02,000	1.11.21	By Bank A/c	1,20,000	6,000	1,14,600
30.11.21	To Bank A/c	80,000	5,000	76,800	1.11.21	By Profit & Loss A/c	-	-	11,400
31.12.21	To Profit & Loss A/c			20,000	31.12.21	By Bank A/c	80,000	6,000	1,04,000
31.03.22	To Profit & Loss A/c		37,250		31.12.21	By Bank A/c	-	13,500	-
	(Bal. fig.)				31.12.21	By Bank A/c	-	6,750	-
					31.3.22	By Bal. c/d	1,80,000	-	1,78,800
		3,80,000	54,750	4,08,800			3,80,000	54,750	4,08,800

Working Notes:

(i) ccrued Interest as on 1st April, 2021 = ₹ 2,00,000 X $\frac{15}{100} x \frac{3}{12}$ = Rs. 7,500

(ii) Accrued Interest as on 1;5;2021 = ₹ 1,00,000 X $\frac{15}{100} x \frac{4}{12}$ = Rs. 5,000

(iii) Cost of Investment for purchase on 1st May = ₹ 1,07,000 – ₹ 5,000 = ₹ 1,02,000

(iv) Interest received as on 30;6;2021 = ₹ 3,00,000X $\frac{15}{100}x\frac{6}{12}$ = Rs. 22,500

(v) Accrued Interest on debentures sold on 1.11.2021 = ₹ 1,20,000 X $\frac{15}{100}x\frac{4}{12}$ = Rs. 6,000

(vi) Accrued Interest = ₹ 80,000 x $\frac{15}{100}x\frac{5}{12}$ 15 × 5 = Rs. 5,000

(vii) Accrued Interest on sold debentures 31;12;2021 = ₹ 80,000 x $\frac{15}{100}x\frac{6}{12}$ = Rs. 6,000

(viii) Sale Price of Investment on 31st Dec; 2021 = ₹ 1,10,000–₹ 6,000 = ₹ 1,04,000

(ix) Loss on Sale of Debenture on 1.11.2021

Sale Price of debenture	1,14,600
Less: Cost Price of debenture2,10,000 / 2,00,000 x Rs.1,20,000	1,26,000
Loss on sale	11,400

(x) Accrued interest as on 31;12;2021 = ₹ 1,80,000 x $\frac{15}{100}x\frac{6}{12}$ = Rs. 13,500

(xi) Accrued Interest = ₹ 1,80,000 x $\frac{15}{100}x\frac{3}{12}$ = ₹ 6,750

(xii) Cost of investment as on 31st March = ₹ 1,02,000 + ₹ 76,800 = ₹ 1,78,800

(xiii) Profit on debentures sold on 31st December

= ₹ 1,04,000 –(₹ 2,10,000x800/2,000) = ₹ 20,000

Question 6: JVR Limited has made investment of ₹ 97/84 Crores in Equity Shares of QSR Limited in 2016-17. The investment has been made at par. QSR Limited has been in continuous losses for the last 2 years. JVR Limited is willing to re-assess the carrying amount of its investment in QSR Limited and wish to provide for diminution in value of investment for the year ended 31st March, 2021. Discuss whether the connection of JVR Limited to bring down the carrying Amount of investment in QSR Limited is in accordance with Accounting Standards.

(RTP May '22)

Answer:

The investments are classified into two categories as per AS 13, viz., Current Investments and Long-term Investments. A current Investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made. The carrying amount for current investments is the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the statement of profit and loss. A long – term investment is an investment other than a current investment. The investments referred in the question can be classified as long-term investments and long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognize the decline. The contention of the company to bring down the value of investment may be correct if the decline in value is permanent in nature and the reduction in carrying amount may be charged to the statement of profit and loss. 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.

Question 7: Gowtham Limited invested in shares of another company (with the intention to hold the shares for short-term period) on 30th November, 2021 at a cost of ₹ 4,25,000/ It also earlier purchased Gold of ₹ 8,00,000 and Silver of ₹ 3,50,000 on 31st March, 2019/ Market values as on 31st March, 2022, of the above investments are as follows:

Shares	**₹ 3,50,000**
Gold	**₹ 10,25,000**
Silver	**₹ 5,10,000**

You are required to explain how will the above investments be shown (individually and in total) in the books of account of Gowtham Limited for the year ending 31st March, 2022 as per the provisions of AS 13. (RTP May 23,)

Answer:

As per AS 13 (Revised) 'Accounting for Investments', for investment in shares – if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (₹ 4,25,000) and market value (₹ 3,50,000) as on 31 March 2022, i;e;, ₹ 3,50,000;

Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 31stMarch, 2019) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31st March, 2022, i;e;, ₹ 8,00,000 and ₹ 3,50,000 respectively, though their market values have been increased.

Thus the shares, gold and silver will be shown at ₹ 3,50,000, ₹ 8,00,000 and ₹ 3,50,000 respectively and hence, total investment will be valued at ₹ 15,00,000 for the year ending on 31st March, 2022 as per AS 13.

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Question 8:

(i) An unquoted long term investment made in the shares of Rachel Limited is carried in the books of Ziva Limited at a cost of ₹ 1,00,000/ The audited financial statements of Rachel Limited received in May,2021 showed that the company had been incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 55,000.

(ii) On 1st December, 2021 Ziva Limited had made an investment of ₹ 5,00,000 in 4,000 Equity Shares of Garry Limited at a price of ₹ 125 per share with an intention to hold it for not more than six months. In the first week of March, 2022, Garry Limited suffered heavy loss due to an earthquake; the loss was not covered by an insurance policy. On 31st March,2022, the shares of Garry Ltd. were traded at a price of ₹ 80 per share on the Stock Exchange/ How would you deal with the above investments in the books of Ziva Limited for the year ended 31st March,2022 as per the provisions of Accounting Standard 13 'Accounting for Investments'? (PYP Nov '22)

Answer:

I. Investments classified as long –term investments should be carried in the financial statements at cost. However, provision for diminution should be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

On this basis, the facts of the given case, it would be appropriate to reduce the carrying value of Long-term investments to ₹ 55,000 in the financial statements for the year ended 31st March, 2022.Thus the unquoted investment in the shares of Rachel Ltd. will be valued at ₹ 55,000

The provision for diminution amounting ₹ 45,000 should be made to reduce the carrying amount of

the investments.

II. Equity Shares in Garry Ltd. will be considered as current investment as intended to hold for not more than six months; As per AS 13, "Accounting for Investments", carrying amount for current investments is the lower of cost and fair value. In respect of current Investments for which as active market exists, market value generally provides the best evidence of fair value.

Since on 31st March,2022, the shares of Garry Limited were trading at a price of ₹ 80 per share on the stock exchange, the equity shares of Garry Ltd. should be carried in the financial statements at realizable value i;e; at ₹ 3,20,000 (4,000 shares @ ₹ 80 per share).The reduction of ₹ 1,80,000 in carrying value of current investment will be charged to the statement of profit and loss for the year ended 31 st March,2022.

Question 9: Mr. Z has made following transactions during the financial year 2020-21:

Investment 1: 8% Corporate Bonds having face value ₹ 100/

Date	Particulars
01-06-2020	Purchased 36,000 Bonds at ₹ 86 cum-interest. Interest is payable on 30th September and 31st March every year
15-02-2021	Sold 24,000 Bonds at ₹ 92 ex-interest

Interest on the bonds is received on 30th September and 31st March.

Investment 2. Equity Shares of G Ltd having face value ₹ 10

Date	Particulars
01-04-2020	Opening balance 8000 equity shares at a book value of ₹ 190 per share
01-05-2020	Purchased 7,000 equity shares@ ₹ 230 on cum right basis- Brokerage of 1% was paid in addition.
15-06-2020	The company announced a bonus issue of 2 shares for every 5 shares held
01-08-2020	The company made a rights issue of 1 share for every 7 shares held at₹ 230 per share. The entire money was payable by 31.08.2020
25-08-2020	Rights to the extent of 30% of his entitlements was sold @ ₹ 75 per share. The remaining rights were subscribed.
15-09-2020	Dividend @ ₹ 6 per share for the year ended 31.03.2020 was received on 16.09.2020. No dividend payable on Right issue and Bonus issue.
01-12-2020	Sold 7 ,000 shares @ 260 per share. Brokerage of 1% was incurred extra.
25-01-2021	Received interim dividend @ ₹ 3 per share for the year 2020-21.
31-03-2021	The shares were quoted in the stock exchange @ ₹ 260/

Both investments have been classified as Current investment in the books of Mr. Z. On 15th May 2021, Mr. Z decides to reclassify investment in equity shares of Z Ltd. as Long term Investment. On 15th May 2021, the shares were quoted in the stock exchange @ ₹ 180/

You are required to:

Prepare Investment Accounts in the books of Mr. Z for the year 2020-21, assuming that the average cost method is followed. Profit and loss Account for the year 2020-21, based on the above information. Suggest values at which investment in equity shares should be reclassified in accordance with AS 13 (MTP Sep '23)

Answer:

a. In the books of Mr. Z

Investment in 8% Corporate Bonds Account For the period 01 April 2020 to 31 March 2021

Date	Particulars	Nos	Interest (₹)	Amount (₹)	Date	Particulars	Nos	Interest (₹)	Amount (₹)
1/6/20	To Bank A/c (WN1)	36,000	48,000	30,48,000	30/9/20	By Bank A/c (Interest 36,000 x 100 x 8% x 6/12)		1,44,000	
15/2/21	To Profit & Loss A/c (WN 3)			1,76,000	15/2/21	By Bank A/c (WN2)	24,000	72,000	22,08,000
31/3/21	To Profit & Loss A/c		2,16,000		31/3/21	By Bank A/c (Interest 12,000 x 100 x 8% x 6/12)		48,000	
						By Balance c/d (WN 4)	12,000		10,16,000
	Total	36,000	2,64,000	32,24,000		Total	36,000	2,64,000	32,24,000

Note: For computing the interest on the bonds sold on 15 Feb 2021, if number of days (138 days) is taken instead of months, the interest received on 15;02;2021 should be ₹ 72,592 and the total interest transferred to Profit & Loss Account should be ₹ 2,16,592; Wrongly printed as Z Ltd. in the Question paper. It should have been given as G Ltd.

Investment in Equity Shares of G Ltd

For the period 1st April 2020 to 31 March 2021

Date	Particulars	Nos	Dividend (₹)	Amount (₹)	Date	Particulars	Nos	Dividend (₹)	Amount (₹)
01/4/20	To Balance b/d	8,000		15,20,000	16/9/20	By Bank A/c (WN 7)		48,000	42,000
01/5/20	To Bank A/c (WN 5)	7,000		16,26,100	1/12/20	By Bank A/c (WN 8)	7000		18,01,800
15/6/20	To Bonus Shares	6,000			25/1/21	By Bank A/c (WN 10)		48,300	
25/8/20	To Bank A/c (Right Shares) (WN 6)	2,100		4,83,000					
01/12/20	To Profit & Loss A/c (Sale of shares) (WN 9)			7,14,800					
31/3/21	To Profit & Loss A/c		96,300		31/3/21	By Balance c/d (WN 11)	16,100		25,00,100
	Total	23,100	96,300	43,43,900		Total	23,100	96,300	43,43,900

Working Notes

1. Computation of the Interest element in the bonds purchased on 01 June 2020

No of Bonds purchased	36,000
Face value per bond	₹ 100
Face value of the bonds purchased	₹ 36,00,000
Interest Rate	8%
Interest Amount	36,00,000 x 8% x 2/12
	₹ 48,000
Cum-interest per bond	₹ 86
Value of bond excluding interest	36,000 x 86 - 48,000

	₹ 30,48,000

2. **Computation of the Interest element in the bonds sold on 15 Feb 2021**

No of Bonds sold	24,000
Face value per bond	₹ 100
Face value of the bonds sold	₹ 24,00,000
Interest Rate	8%
Interest Amount	24,00,000 x 8% x 4;5/12 = ₹ 72,000

3. **Computation of Profit on Sale of Bonds on 15 Feb 2021**

No of Bonds sold	24,000
Face value per bond	₹ 100
Ex- interest Rate per bond	₹ 92
Sales proceeds	₹ 22,08,000
Average Cost of Bonds	(30,48,000/36,000) x 24,000
	₹ 20,32,000
Profit on sale of bonds	Sale Proceeds - Average Cost
	22,08,000 - 20,32,000
	₹ 1,76,000

4. **Valuation of Bonds as on 31 March 2021**

No of Bonds held as on 31 Mar 2021	12,000
Average Cost of Bonds	(30,48,000/36,000) x 12,000
	₹ 10,16,000

5. **Computation of the cost of the equity shares purchased on 01 May 2020**

No of shares purchased	7,000
Cum right price per share	₹ 230
Cost of purchase	₹ 16,10,000
Brokerage @1%	₹ 16,100
Cost including brokerage	₹ 16,26,100

6. **Right Shares**

No of Right Shares Issued	(8,000+7,000+6,000)/7 = 3,000 shares
No of right shares sold	3,000 shares x 30% = 900 shares
Proceeds from sale of right shares to be credited to statement of profit & loss	900 shares x ₹ 75 = ₹ 67,500
No of right shares subscribed	3,000-900 = 2,100 shares
Amount of right shares subscribed	2,100 x 230 = ₹ 4,83,000

7. **Computation of Dividend Received on 16 Sept 2020**

No of shares held during the period of dividend	8,000 shares
Dividend per share	₹ 6
Dividend Amount	8,000 x 6 = ₹ 48,000
No of shares received after the period of dividend (excluding bonus & right shares)	7,000 shares
Dividend per share	₹ 6
Dividend Amount	7,000 x 6 = ₹ 42,000

The amount of dividend for the period for which the shares were not held by the investor has been treated as capital receipt; Thus ₹ 42,000 shall be treated as receipt;

8. **Sale Proceeds for the shares sold on 1st Dec. 2020**

No of shares sold	7,000 Shares
Sale price per share	₹ 260
Proceeds from sale of share	7,000 x 260 = ₹ 18,20,000
Less: Brokerage @ 1%	₹ 18,200
Net Sale Proceeds	₹ 18,01,800

9. **Profit on sale of shares on 1st Dec. 2020**

Sales Proceeds	₹ 18,01,800
Average Cost	(15,20,000+16,26,100+4,83,000–42,000)/23,100x7000
	= ₹ 10,87,000
Profit on sale of shares	Sales Proceeds – Average Cost
	= ₹ 18,01,800–10,87,000 = ₹ 7,14,800

10. **Computation of Amount of Interim Dividend**

No of shares held	8,000+7,000+6,000+2,100–7,000
	= 16,100
Dividend per share	₹ 3 per share
Dividend Received	16,100 shares x ₹ 3 per share
	= ₹ 48,300

11. **Valuation of Shares as on 31 March 2021**

Cost of Shares	(15,20,000 + 16,26,100 + 4,83,000 – 42,000) / 23,100 x 16,100
	= 25,00,100
Market Value of Shares	₹ 260 x 16,100 = ₹ 41,86,000
Closing stock of equity shares has been value at ₹ 25,00,100 i;e; cost being lowerthan its market value.	

b. **Profit & Loss Account (Extract)**

For the period 01 April 2020 to 31 March 2021

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance c/d	12,70,600	By Investment in 8% Corporate Bonds Account (Profit on sale of bonds)	1,76,000
		By Investment in 8% Corporate Bonds Account (Interest on bonds)	2,16,000
		By Sale of Right Shares	67,500
		By Investment in Equity Shares of G Ltd (Profit on sale of shares)	7,14,800
		By Investment in Equity Shares of G Ltd (Dividend Income)	96,300

c. As per AS 13, when investments are classified from Current Investments to Long term Investments, transfer is made at Cost and Fair value, whichever is less (as on the date of transfer). So, in the given case valuation shall be done as follows:

Date of reclassification/transfer – 15 May 2021

Per Unit Cost of 16,100 shares held – ₹ 25,00,100/16,100 shares – ₹ 155;29

Market Price/Fair Value per share – ₹ 180

As the cost per unit is lower than its fair value, the shares are to be transferred at its cost i;e;, at ₹ 155.29 per share on 15 May 2021

Note:

i. In the eight last line of the Question, investment in equity shares of G Ltd. was wrongly printed as Z Ltd. in the Question paper. In the above Solution:, it has been considered as investment in G Ltd. If considered as Investment in equity shares in Z Ltd. (some other investment and not investment in G Ltd.), then the cost of the investment for shares in Z Ltd. will not be available.

ii. The entire amount of sale proceeds from rights has been credited to Profit and Loss account in the above Solution:. However, the sale proceeds of rights in respect of 7,000 shares (purchased cum right on 1.5.20) can be applied to reduce the carrying amount of such investments (without crediting it to profit and loss account) considering that the value of these shares has reduced after becoming their ex –right; In that case, ₹ 22,500 (67,500X 7/21) will be applied to reduce the carrying amount of investment and ₹ 45,000 will be credited to profit and loss account;

Question 10: On 1st April, 2024 Mr. Zoom had an opening balance of 1000 equity shares of P Ltd. Rs. 1,20,000 (face value Rs. 100 each).
On 5.04.2024 he further purchased 200 cum-right shares for Rs. 135 each. On 8.04.2024 the director of P Ltd announced right issue in the ratio of 1:6.
Mr. Zoom waived off 100% of his entitlement of right issue in the favour of Mr. X at the rate of Rs. 20 each.
All the shares held by Mr. Zoom had been acquired on cum right basis and the total market price (ex-right) of all these shares after the declaration of rights got reduced by Rs. 3,400.
On 10.10.2024 Zoom sold 350 shares for Rs. 140 each.
31.03.2025 The market price of each share is Rs. 125 each.
You are required to prepare the Investment account in the books of Mr. Zoom for the year ended 31.03.2025 assuming that the shares are being valued at average cost.
(MTP May 25 S1 7M)

Answer:

In the books of Mr. Zoom
for the year ending on 31.3.2025
(Scrip: Equity Shares of P Limited)

Date	Particulars	Qty	Amount	Date	Particulars	Qty	Amount
1.4.2024	To Balance b/d	1000	1,20,000	8.04.2024	By Bank A/c (W.N.1)		3,400
5.04.2024	To Bank (200x Rs.135)	200	27,000	10.10.2024	By Bank A/c (350x Rs.140)	350	49,000
10.10.2024	To Profit & Loss A/c (W.N.2)		7,117	31.3.2025	By Balance c/d (W.N.3)	850	1,01,717
		1200	1,54,117			1200	1,54,117

Working Notes:

1. **Sale of Rights** Rs. 4,000
   The market price of all shares of P Ltd after shares becoming ex-rights has been reduced by Rs. 3,400

In this case out of sale proceeds of Rs.4,000; Rs. 3,400 may be applied to reduce the carrying amount to the market value and Rs. 600 would be credited to the profit and loss account.

2. **Profit on sale of 350 shares**

	Amount Rs.
Sale price of 350 shares (350 shares X 140 each)	49,000
Less: Cost of 350 shares [(1,20,000+27,000-3,400) X350]/1200	41,883
Profit	7,117

3. **Valuation of 850 shares as on 31.03.2025**

Particulars	**Amount**
Cost price of 850 shares [(1,20,000 +27,000 -3,400) x 850 /1,200]	Rs. 1,01,717
Fair Value as on 31.03.2020 [850 X Rs. 125 each]	Rs. 1,06,250
Cost price or fair value whichever is less	Rs. 1,01,717

Question 11: On 15th June, 2024, Y limited wants to re-classify its investments in accordance with AS 13 (revised). Decide and state the amount of transfer, based on the following information:

(1) A portion of long-term investments purchased on 1st March, 2023 are to be re-classified as current investments. The original cost of these investments was Rs. 14 lakhs but had been written down by Rs. 2 lakhs (to recognise 'other than temporary' decline in value). The market value of these investments on 15th June, 2024 was Rs. 11 lakhs.

(2) Another portion of long-term investments purchased on 15th January, 2023 are to be re-classified as current investments. The original cost of these investments was Rs. 7 lakhs but had been written down to Rs. 5 lakhs (to recognize 'other than temporary' decline in value). The fair value of these investments on 15th June, 2024 was Rs. 4.5 lakhs.

(3) A portion of current investments purchased on 15th March, 2024 for Rs. 7 lakhs are to be re-classified as long-term investments, as the company has decided to retain them. The market value of these investments on 31st March, 2024 was Rs. 6 lakhs and fair value on 15th June 2024 was Rs. 8.5 lakhs.

(4) Another portion of current investments purchased on 7th December, 2023 for Rs. 4 lakhs are to be re-classified as long-term investments. The market value of these investments was: on 31st March, 2024 Rs. 3.5 lakhs on 15th June, 2024 Rs. 3.8 lakhs (MTP Sep 24 S1 7M)

Answer:

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

Accordingly, the re-classification will be done on the following basis:

(i) In this case, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at Rs. 12 lakhs in the books.

(ii) In this case also, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at Rs. 5 lakhs in the books.

(iii) In this case, reclassification of current investment into long-term investments will be made at Rs. 7 lakhs as cost is less than its fair value of Rs. 8.5 lakhs on the date of transfer.

(iv) In this case, market value (considered as fair vale) is Rs. 3.8 lakhs on the date of transfer which is lower than the cost of Rs. 4 lakhs. The reclassification of current investment into long-term investments will be made at Rs. 3.8 lakhs.

Question 12: A Ltd. purchased on 1st April, 2023 8% convertible debenture in C Ltd. of face value of Rs. 2,00,000 @ Rs. 108. On 1st July, 2023 A Ltd. purchased another Rs. 1,00,000 debentures @ Rs. 112 cum interest. On 1st October, 2023 Rs. 80,000 debentures were sold @ Rs. 105. On 1st December, 2023, C Ltd. give option for conversion of 8% convertible debentures into equity share of Rs. 10 each. A Ltd. received 5,000 equity shares in C Ltd. in conversion of 25% debentures held on that date. The market price of debenture and equity share in C Ltd. on 31st December, 2023 is Rs. 110 and Rs. 15 respectively. Interest on debenture is payable each year on 31st March, and 30th September. Prepare investment account in the books of A Ltd. on average cost basis for the accounting year ended 31st December, 2023. (MTP Sept 24 S2 10M)

Answer:

Investment Account for the year ending on 31st December, 2023

Scrip: 8% Convertible Debentures in C Ltd.

[Interest Payable on 31st March and 30th September]

Date	Particulars	Nominal value Rs.	Interest Rs.	Cost Rs.	Date	Particulars	Nominal Value (Rs.)	Interest (Rs.)	Cost (Rs.)
1.4.23	To Bank A/c	2,00,000	-	2,16,000	30.09.23	By Bank A/c	-	12,000	-
1.7.23	To Bank A/c (W.N.1)	1,00,000	2,000	1,10,000		[Rs.3,00,000 x 8% x (6/12]			
31.12.23	To P & L A/c [Interest]	-	14,033	-	1.10.23	By Bank A/c		80,000	84,000
					1.10.23	By P & L A/c (loss) (W.N.3)			2,933
					1.12.23	By Bank A/c (Accrued interest) (Rs. 55,000 x .08 x 2/12)		733	
					1.12.23	By Equity shares in C Ltd. (W.N. 3 and 4)	55,000		59,767
					31.12.23	By Balance c/d (W.N.5)	1,65,000	3,300	1,79,300
		3,00,000	16,033	3,26,000			3,00,000	16,033	3,26,000

SCRIP: Equity Shares in C LTD.

Date	Particulars	Cost (Rs.)	Date	Particulars	Cost (Rs.)
1.12.23	To 8 % debentures	59,767	31.12.23	By balance c/d	59,767

Working Notes:

(i) Cost of Debenture purchased on 1st July = Rs. 1,12,000 – Rs. 2,000 (Interest) = Rs.1,10,000

(ii) Cost of Debentures sold on 1st Oct.

= (Rs. 2,16,000 + Rs. 1,10,000) x 80,000/3,00,000 = Rs. 86,933

(iii) Loss on sale of Debentures = Rs. 86,933- Rs.84,000 = Rs. 2,933

Nominal value of debentures converted into equity shares

=Rs. 55,000

[(Rs. 3,00,000 – 80,000) x.25]

Interest received before the conversion of debentures

Interest on 25% of total debentures = 55,000 x 8% x 2/12 = 733

(iv) Cost of Debentures converted = (Rs. 2,16,000 + Rs.1,10,000) x 55,000/3,00,000 = Rs. 59,767

(v) Cost of closing balance of Debentures = (Rs. 2,16,000 + Rs.1,10,000) x 1,65,000 / 3,00,000

= Rs. 1,79,300

(vi) Closing balance of Debentures has been valued at cost.

(vii)5,000 equity Shares in C Ltd. will be valued at cost of Rs. 59,767 being lower than the market value Rs. 75,000 (Rs. 15 x5,000)

Question 13: The following information is given for Mr. Atwood for the year ended 31.03.2025:

01.04.2024	**Mr. Atwood has 3,000 equity shares in Sun Limited at a book value of ₹ 3,30,000 (nominal value ₹ 100 each.)**
01.07.2024	**Purchased 1,500 equity shares in Sun Limited for ₹ 1,38,600.**
01.08.2024	**Purchased 5,000.9% Bonds at ₹ 97 cum-interest (face value ₹ 100). The due dates of interest are 1st September and 1st March.**
02.10.2024	**Dividend declared on equity shares and paid by Sun Limited for the year 2023-2024 @ 10%.**
15.10.2024	**Sun Limited made a bonus issue of two equity shares for every five shares held.**
01.01.2025	**1,000 equity shares in Sun Limited sold @ ₹ 115 per share.**
31.03.2025	**Sold 4,000,9% Bonds @ ₹ 99 ex-interest**

- **The market price of Equity Shares of Sun Limited is ₹ 125 each and Bonds ₹ 98 each on 31st March 2025.**
- **Interest on bonds was received on due dates.**

You are required to prepare Investment Account in the books of Mr. Atwood for the year ended 31stMarch 2025, assuming that the investments are valued at the average cost or market value, whichever is lower. (Round off to nearest Rupee) (MTP Sept 25 S2 14 Marks)

Answer:

In the books of Atwood

Investment in Equity Shares of Sun Ltd. Account

Date	Particulars	No.	Dividend (₹)	Amount (₹)	Date	Particulars	No.	Dividend (₹)	Amount (₹)
1.04.24	To Balance b/d	3,000		3,30,000	2.10.24	By Bank A/c (W.N. 5)		30,000	15,000
1.07.24	To Bank A/c	1,500		1,38,600	1.1.25	By Bank A/c	1,000		1,15,000
15.10.24	To Bonus Issue	1,800			31.3.25	By Balance c/d (W.N.7)	5,300		3,81,600
1.01.25	To Profit & Loss A/c (W.N. 6)			43,000					
31.3.25	To Profit & Loss A/c		30,000						
		6,300	30,000	5,11,600			6,300	30,000	5,11,600

9% Bonds Account [Interest Payable: 1st September & 1st March]

Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)	Date	Particulars	Nominal Value (₹)	Interest (₹)	Cost (₹)
1.8.24	To Bank A/c (W.N.1)	5,00,000	18,750	4,66,250	1.9.24	By Bank A/c (5,00,000 x 9% x 6/12)	-	22,500	-
31.3.25	To Profit & Loss A/c (W.N 3)			23,000	1.3.25	By Bank A/c	-	22,500	-
31.3.25						By Bank A/c (W.N 2)	4,00,000	3,000	3,96,000
31.3.25	To Profit & Loss A/c		30,000		31.3.25	By Balance c/d (W.N.4)	1,00,000	750	93,250
		5,00,000	48,750	4,89,250			5,00,000	48,750	4,89,250

Working Notes:

1. **Cost of Bond purchased on 1st August, 2024**
   5,000, 9% bonds were purchased @ ₹ 97 cum-interest. Total amount paid 5,000 bonds x ₹ 97 = 4,85,000 which includes accrued interest for 5 months, i.e., 1st March, 2024 to 31st July, 2024. Accrued interest will be ₹ 5,00,000 x 9/100x 5/12 = ₹ 18,750. Therefore, cost of Bond purchased = ₹ 4,85,000 – 18,750 = ₹ 4,66,250.
2. **Sale of bonds on 31st March, 2025**
   4,000 bonds were sold@ ₹ 99 ex-interest, i.e., Total amount received = 4,000 x 99 + accrued interest for 1 month = ₹ 3,96,000 + ₹ 3,000 (4,00,000 x 9/100 x 1/12)
3. **Profit on sale of bonds** ₹
   Sale value = 3,96,000
   Cost of 4,00,000 9% bonds = 4,66,250/5,000x 4,000 = 3,73,000
   Profit = **23,000**
4. **Value of bonds on 31.3.2025**
   Lower of:
   Cost of bonds on 31.3.2025 will be ₹ 4,66,250/ 5,000 x 1,000 = ₹ 93,250.
   Market Value on 31.3.2025 will be ₹ 1,000 X 98 = 98,000
   Value of bonds on 31.3.2025 = ₹ 93,250
   Interest accrued on bonds on 31.3.2025 = 1,00,000 x 9% x 1/12 = ₹ 750
5. **5. Dividend on equity shares for 2023-24**
   Post acquisition dividend = 3,00,000 x 10% = ₹ 30,000 transferred to Profit & Loss account
   Pre-acquisition dividend = 1,50,000 X 10% = ₹ 15,000 credited to investment A/c
6. **Profit on sale of equity shares** ₹
   Sale value = 1,15,000
   Cost of shares = 4,53,600 / 6,300 x 1,000 = 72,000
   Profit = 43,000
   (Average cost method being followed)
7. **Value of equity shares at end of year**
   Lower of:
   Cost of shares on 31.3.2025 will be ₹ 4,53,600 / 6,300 x 5,300 = ₹ 3,81,600
   Market Value on 31.3.2025 will be ₹ 5,300 x 125 = 6,62,500
   Value of shares = ₹ 3,81,600

Question 14: On 1st April 2024, Kesar held 75,000 equity shares of Beta Ltd., recorded at a book value of ₹ 15 per share (with a nominal value of ₹ 10 each). The following transactions took place during the year:

1. **On 20th June 2024, Kesar purchased 15,000 additional shares of Beta Ltd. at ₹ 16 per share.**
2. **On 1st August 2024, Beta Ltd. declared a bonus issue of one share for every six shares held.**
3. **On 31st October 2024, the company announced a rights issue, offering three shares for every seven held at a price of ₹ 15 per share. Shareholders were allowed to fully or partially renounce their rights.**

Kesar sold one-third of his rights entitlement to Megha at ₹ 2 per share and subscribed to the remaining rights on 5th November 2024.

You are required to prepare the Investment Account in the books of Kesar for the year ending 31st March 2025. (RTP Sept 25)

Answer:

In the books of Kesar

Investment Account

(Equity shares in Beta Ltd.)

Date	Particulars	No. of shares	Amount (₹)	Date	Particulars	No. of shares	Amount (₹)
1.4.24	To Balance b/d	75,000	11,25,000	31.3.25	By Balance c/d (Bal. fig.)	1,35,000	18,15,000
20.6.24	To Bank A/c	15,000	2,40,000				
1.8.24	To Bonus issue (W.N.1)	15,000				-	
5.11.24	To Bank A/c (right shares) (W.N.4)	30,000				4,50,000	
		1,350,000	18,15,000			1,350,000	18,15,000

Working Notes:

(1) Bonus shares = 75,000 + 15,000 / 6 = 15,000 shares

(2) Right shares = 75,000 + 15,000 + 15,000 / 7 = 45,000 shares 3×

(3) Sale of rights = 45,000 shares × 1/3 × ₹ 2 = ₹ 30,000 to be credited to statement of profit and loss

(4) Rights subscribed = 45,000 shares ×2/3× ₹ 15 = ₹ 4,50,000

Question 15: Ms. Neha had 20,000 Equity shares in Nexus Ltd. at a book value of ₹ 2,40,000 on 01.04.2024. Face value of shares is ₹ 10 per share.

The Directors of Nexus Ltd. announced a bonus of equity shares in the ratio of one share for every 5 shares held on 30/04/2024.

On 31/07/2024 the company made a right issue in the ratio of three shares for every 4 shares held, on payment of ₹ 14 per share. The due date for payment was 31/08/2024. Ms. Neha opted to subscribe 50% of the right shares and sold the remaining of her entitlement to Ms. Rewa for a consideration of ₹ 3 per share.

On 08/10/2024, Ms. Neha received dividend from Nexus Ltd. @ 15% for the year ended 31/03/2024.

On 01/11/2024, Neha sold 11500 shares at a premium of ₹ 16 per share.
You are required to prepare Investment A/c as per AS -13 in the books of Ms. Neha for the year ended 31/03/2025 assuming that the shares are being valued at average cost.
(PYP May 25 7M)

Answer:

Alternative -1

Considering the Examinee has calculated Average Cost directly for shares sold and for Closing Balance of Shares:

Investment Account in Books of Ms. Neha
(Scrip: Equity Shares in Nexus Ltd.)

		No.	Amount ₹			No.	Amount ₹
1.4.2024	To Bal b/d	20,000	2,40,000	1.11.2024	By Bank	11,500	2,99,000
30.4.2024	To Bonus	4,000	_		(Sale of shares)		
31.8.2024	To Bank (Rights Shares)	9,000	1,26,000	31.3.2025	By Bal. c/d	21,500	2,38,455
1.11.2024	To P&L A/c (Profit on sale of shares)		1,71,455				
		33,000	5,37,455			33,000	5,37,455

Working Notes:

(1) Bonus Shares = (20,000) /5 = **4,000** shares

(2) Right Shares = (20,000 + 4,000) / 4× 3 = 18,000 shares

(3) Rights shares sold = 18,000×50% = 9,000 shares

(4) Dividend received = 20,000×10×15% = ₹ 30,000 will be taken to P&L statement

(5) Average Cost of shares sold:

Average Cost = (2, 40,000+1,26,000) / 33,000 x 11,500
= ₹ 1,27,545

(6) Profit on sale of 11,500 shares

= Sales proceeds – Average cost

Sales proceeds = ₹ 2,99,000

Profit = ₹ 2,99,000– ₹ 1,27,545= ₹ **1,71,455**.

(7) Cost of shares on 31.3.2025

(2, 40,000+1,26,000) / 33,000 x 21,500 = 2,38,455

(8) Sale of rights amounting ₹ 27,000 (₹ 3 x 9,000 shares) will not be shown in investment A/c but will directly be taken to P & L statement.

Alternative - 2

Calculate Average Cost per Unit first and then worked out the cost of shares sold and closing balance of shares using average unit cost:

Investment Account in Books of Ms. Neha
(Scrip: Equity Shares in Nexus Ltd.)

No.		Amount ₹		No.		Amount ₹	
1.4.2024	To Bal b/d	20,000	2,40,000	1.11.2024	By Bank	11,500	2,99,000
30.4.2024	To Bonus	4,000	_		(Sale of shares)		
31.8.2024	To Bank (Rights Shares)	9,000	1,26,000	31.3.2025	By Bal. c/d	21,500	2,38,435

1.11.2024	To P&L A/c (Profit on sale of shares)		1,71,435(*)				
		33,000	5,37,435			33,000	5,37,435

(*) rounding off difference of ₹ 30 adjusted i.e. 1,71,465 – 30 = 1,71,435

Working Notes:

(1) **Bonus Shares** = (20,000) /5 = 4,000 shares

(2) **Right Shares** = (20,000+4,000) / 4 x 3 = 18,000 shares

(3) **Rights shares sold** = 18,000×50% = 9,000 shares

(4) **Dividend received** = 20,000×10×15% = ₹ 30,000 will be taken to P&L statement

(5) **Average Cost per Share:**

= (2,40,000 + 1,26,000) / (20,000 + 4,000 + 9,000)

= (3,66,000 / 33,000)

= 11.09 per share (rounded off to 2-decimal places)

Average Cost = (11,500 × 11.09) = ₹ 1,27,535

(6) **Profit on sale of 11,500 shares**

= Sales proceeds – Average cost

Sales proceeds = ₹ 2,99,000

Profit = ₹ 2,99,000 – ₹ 1,27,535 = ₹ 1,71,465.

(7) **Cost of shares on 31.3.2025**

21,500 x 11.09 = ₹ 2,38,435

(8) Sale of rights amounting ₹ 27,000 (₹ 3 x 9,000 shares) will not be shown in investment A/c but will directly be taken to P & L statement.

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AS - 15: Employee Benefits

Illustrations

Illustration 1

What are the kinds of employees covered in the revised AS 15 and whether a formal employer employee relationship is necessary or not, for benefits to be covered under the Standard?

Solution:

The Standard does not define the term "employee". Paragraph 6 of the Standard states that 'an employee may provide services to an enterprise on a full time, part time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The Standard is applicable to all forms of employer employee relationships. There is no requirement for a formal employer employee relationship. Several factors need to be considered to determine the nature of relationship.

Generally, 'outsourcing contracts' may not meet the definition of employer - employee relationship. However, such contracts need to be carefully examined to distinguish between a "contract of service" and a "contract for services". A 'contract for services' implies a contract for rendering services, e.g., professional or technical services which is subject to limited direction and control whereas a 'contract of service' implies a relationship of an employer and employee, and the person is obliged to obey orders in the work to be performed and as to its mode and manner of performance.

Illustration 2

Whether an enterprise is required to provide for employee benefits arising from informal practices?

Solution:

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Paragraph 3(c) of the Standard defines employee benefits to include those informal practices that give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. The historical pattern of granting such benefits, the expectation created and the impact on the relationship with employees in the event such benefit is withdrawn should be considered in determining whether the informal practice gives rise to a benefit covered by the Standard. For example, where an employer has a practice of making a lumpsum payment on occasion of a festival or regularly grants advances against informal benefits to employees it would be necessary to provide for such benefits.

Careful judgement should be applied in assessing whether an obligation has arisen particularly in instances where an enterprise's practice is to provide improvements only during the collective bargaining process and not during any informal process. If the employer has not set a pattern of benefits that can be projected reliably to give rise to an obligation there is no requirement to provide for the benefits.

However, if the practice established by an employer was that of a consistent benefit granted either as part of union negotiations or otherwise that clearly established a pattern (e.g., a cost of living adjustment or fixed rupee increase), it could be concluded that an obligation exists and that those additional benefits should be included in the measurement of the benefit obligation.

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, postemployment 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.

Illustration 3

Entity XY is required to pay salary of Rs.2 crore for the year 20X1-X2. It actually paid a salary of Rs.1.90 crore up to 31st March 20X2, and balance in April 20X2. Determine the actual costs to be recognized in the year 20X1-X2 and any amounts to be shown through balance sheet.

Solution:

Total expense for the year (20X1-X2)	Rs.2 crore
Amount to be shown under liability (unpaid)	Rs.2 crore – Rs.1.90 crore
	= Rs.10 lakhs

Illustration 4

Whether an entitlement to earned leave which can be carried forward to future periods is a short -term employee benefit or a long-term employee benefit.

Solution:

Paragraph 7.2 of the Standard defines 'Short-term' benefits as employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service.

Paragraph 8(b) of the Standard illustrates the term 'Short -term benefits' to include "short term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service".

Paragraph 7.2 of the Standard uses "falls due" as the basis, paragraph 8(b) of the Standard uses "expected to occur" as the basis to illustrate classification of short term compensated absences. A reading of paragraph 8(b) together with paragraph 7.2 would imply that the classification of short - term compensated absences should be only when absences have "fallen due" and are also "expected to occur". In other words, where employees are entitled to earned leave which can be carried forward to future periods, the benefit would be a 'short-term benefit' provided the employee is entitled to either encash or utilise the benefit during the twelve months after the end of the period when the employee became entitled to the leave and is also expected to utilise the leave.

Where there are restrictions on encashment and/or availment, clearly the compensated absence has not fallen due and the benefit of compensated absences is more likely to be a long-term benefit. For example, where an employee has 100 days of earned leave which he is entitled to an unlimited carry forward, but the rules of the enterprise allow him to encash/utilise only 30 days during the next twelve months, the benefit would be considered as a 'long-term' benefit. In some situations, where there is no restriction but the absence is not expected to wholly occur in the next twelve months, the benefit should be considered as 'long-term'. For example, where an employee has 400 days carry forward earned leave and the past pattern indicates that the employees are unlikely to avail / encash the entire carry forward during the next twelve months, the benefit would not be 'short-term'.

Whilst it is necessary to consider the earned leave which "falls due", the pattern of actual utilisation/encashment by employees, although reflective of the behavioural pattern of employees, does determine the status of the benefit, i.e., whether 'short-term' or 'long-term'. The value of short-term

benefits should be determined without discounting and if the benefit is determined as long-term, it would be recognised and measured as "Other long-term benefits" in accordance with paragraph 129 of the Standard.

The categorisation in 'short-term' or 'long-term' employee benefits should be done on the basis of the overall behavioural pattern of all the employees of the enterprise and not on individual basis.

Illustration 5

In case an enterprise allows unutilised employee benefits, e.g., medical care, leave travel, etc., to be carried forward, whether it is required to recognise a provision in respect of carried forward benefits.

Solution:

A provision should be recognised for all benefits (conditional or unconditional) which an employee becomes entitled to as a result of rendering of the service and should be recorded as part of the cost of service rendered during the period in which the service was rendered which resulted the entitlement. In estimating the cost of such benefit the probability of the employee availing such benefit should be considered.

Illustration 6

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 Rs.6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs.2 lakhs instead of Rs.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 finalization of accounts, taking note of the mandatory accounting standards.

Solution:

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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 Rs.6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 7

As on 1st April, 20X1 the fair value of plan assets was Rs.1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 20X1 the plan paid out benefits of Rs.19,000 and received inward contributions of Rs.49,000. On 31st March, 20X2 the fair value of plan assets wasRs.1,50,000 and present value of the defined benefit obligation was Rs.1,47,920. Actuarial losses on the obligations for the year 20X1-20X2 were Rs.600.

On 1st April, 20X1, 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.

Solution:

Computation of Expected and Actual Returns on Plan Assets

	Rs.
Return on Rs.1,00,000 held for 12 months at 10.25%	10,250
Return on Rs.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 20X1-20X2	11,750
Fair value of plan assets as on 31 March, 20X2	1,50,000
Less: Fair value of plan assets as on 1 April,20X1	1,00,000
Contributions received 49,000	(1,49,000)
	1,000
Add: Benefits paid	19,000
Actual return on plan assets	20,000

Alternatively, the above question may be solved without giving compound effect to rate of return.

Illustration 8

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. 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 Rs.18 (10% of Rs.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 Rs.6,000 based on current actuarial assumption.

(b) The fair value of plan assets on the date is estimated at Rs.5,100.

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

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

Solution:

Gain from curtailment is estimated as under:

	Rs.
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:

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

Illustration 9

An employee Roshan has joined a company XYZ Ltd. in the year 20X1. The annual emoluments of Roshan as decided is Rs.14,90,210. The company also has a policy of giving a lump sum payment of 25% of the last drawn annual salary of the employee for each completed year of service if the employee retires after completing minimum 5 years of service. The salary of the Roshan is expected to grow @ 10% per annum.

The company has inducted Roshan in the beginning of the year and it is expected that he will complete the minimum five year term before retiring. Thus he will get 5 yearly increment.

What is the amount the company should charge in its Profit and Loss account every year as cost for the Defined Benefit obligation? Also calculate the current service cost and the interest cost to be charged per year assuming a discount rate of 8%.

(P.V factor for 8% - 0.735, 0.794, 0.857, 0.926, 1)

Solution:

Calculation of Defined Benefit Obligation (DBO)

Expected last drawn salary = Rs.14,90,210 x 110% x 110% x 110% x 110% x 110%
= Rs.24,00,000

Defined Benefit Obligation (DBO) = Rs.24,00,000 x 25% x 5 = Rs.30,00,000

Amount of Rs.6,00,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost

Year	Equal apportioned amount of DBO [i.e. Rs.30,00,000/5 years]	Discounting @ 8% PV factor	Current service cost (Present Value)
a	b	c	d = b x c
1	6,00,000	0.735 (4 Years)	4,41,000
2	6,00,000	0.794 (3 Years)	4,76,400
3	6,00,000	0.857 (2 Years)	5,14,200
4	6,00,000	0.926 (1 Year)	5,55,600
5	6,00,000	1 (0 Year)	6,00,000

Calculation of Interest Cost to be charged per year

Year	Opening balance	Interest cost	Current service cost	Closing balance
a	**b**	**c = b x 8%**	**d**	**e = b + c + d**
1	0	0	4,41,000	4,41,000
2	4,41,000	35,280	4,76,400	9,52,680
3	9,52,680	76,214	5,14,200	15,43,094
4	15,43,094	1,23,447	5,55,600	22,22,141
5	22,22,141	1,77,859*	6,00,000	30,00,000

*Due to approximations used in calculation, this figure is adjusted accordingly.

Test Your Knowledge

1. **Gratuity and Pension would be examples of:**
   (a) Short-term employee benefits
   (b) Long-term employee benefits
   (c) Post-employment benefits.
   (d) None of the above.

2. **Non-accumulating compensating absence is commonly referred to as:**
   (a) Earned Leave
   (b) Sick Leave
   (c) Casual leave
   (d) All of the above

3. **The plans that are established by legislation to cover all enterprises and are operated by Governments include:**
   (a) Multi-Employer plans
   (b) State plans
   (c) Insured Benefits
   (d) Employee benefit plan

4. **Best estimates of the variable to determine the eventual cost of postemployment benefits is referred to as:**
   (a) Employer's contribution
   (b) Actuarial assumptions
   (c) Cost to Company
   (d) Employee's contribution

5. **Actuarial gains / losses should be:**
   (a) Recognised through reserves
   (b) Charged over the expected life of employees
   (c) Charged immediately to Profit and Loss Statement
   (d) Do not charged to Profit and Loss Statement

Answer to the Multiple Choice Questions

1.	(c)	2.	(c)	3.	(b)	4.	(b)	5.	(c)

Theoretical Questions

6. What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS 15?

Answer:

There are four types of employee benefits according to AS 15 (Revised 2005). They are:

(a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and

(d) termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Statement establishes separate requirements for each category.

The objective of AS 15 is to prescribe the accounting and disclosure for employee benefits. The statement requires an enterprise to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

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Scenario Based Questions

7. A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively, employees can claim a lump sum amount equal to one month pay last drawn.

The company's contentions in this matter are:

(i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.

(ii) Since it is not related to the length of service of the employees, it is accounted for on claim basis.

State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.

Answer:

The present case falls under the category of defined benefit scheme under Para 49 of AS 15 (Revised) "Employee Benefits". The said para encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).

(2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

8. The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.20X2 calculate the actual return on plan assets:

- **Benefits paid 2,00,000**
- **Employer contribution 2,80,000**
- **Fair market value of plan assets on 31.03.20X2 11,40,000**
- **Fair market value of plan assets as on 31.03.20X1 8,00,000**

Answer:

		Rs.
Fair value of plan assets on 31.3.20X1		8,00,000
Add: Employer contribution		2,80,000
Less: Benefits paid		(2,00,000)
	(A)	8,80,000
Fair market value of plan assets at 31.3.20X2	(B)	11,40,000
Actual return on plan assets	(B-A)	2,60,000

9. **The fair value of plan assets of Anupam Ltd. was Rs.2,00,000 in respect of employee benefit pension plan as on 1st April, 20X1. On 30th September, 20X1 the plan paid out benefits of Rs.25,000 and received inward contributions of Rs.55,000. On 31st March, 20X2 the fair value of plan assets was Rs.3,00,000.**

On 1st April, 20X1 the company made the following estimates, based on its market studies and prevailing prices.

	%
Interest and dividend income (after tax) payable by fund	**10.25**
Realized gains on plan assets (after tax)	**3.00**
Fund administrative costs	**(3.00)**
Expected rate of return	**10.25**

Calculate the expected and actual returns on plan assets as on 31st March, 20X2, as per AS 15.

Answer:

Computation of Expected Returns on Plan Assets as on 31st March, 20X2, as per AS 15

	Rs.
Return on opening value of plan assets of Rs.2,00,000 (held for the year) @ 10.25%	20,500
Add: Return on net gain of Rs.30,000 (i.e. Rs.55,000 – Rs.25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets as on 31st March, 20X2	22,000

Computation of Actual Returns on Plan Assets as on 31st March, 20X2, as per AS 15

	Rs.	Rs.
Fair value of Plan Assets as on 31st March, 20X2		3,00,000
Less: Fair value of Plan Assets as on 1st April, 20X1	(2,00,000)	
Add: Contribution received as on 30th September, 20X1	55,000	(2,55,000)
		45,000
Add: Benefits paid as on 30th September, 20X1		25,000
Actual returns on Plan Assets as on 31st March, 20X2		70,000

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: Pendora Ltd. has given the following details in respect of employee benefitpension plan:

Particulars	Amount Rs.
The fair value of plan assets as on 01-04-2023	5,00,000
The benefits paid out on 30-11-2023	63,000
Inward contributions received on 30-09-2023	1,42,000
The fair value of plan assets as on 31-03-2024	7,50,000

On 01.04.2023, the company made following estimates, based on its market studies and prevailing prices:

Particulars	%
Interest and dividend income (after tax) payable by fund	10.50
Realised gains on plan assets (after tax)	2.00
Fund administrative costs	-2.00
Expected rate of annual return (Interest is compounded annually)	10.50

You are required to find the expected and actual returns on plan assets as on 31.03.2024 as per AS 15. (PYP Sept 24)

Answer:

Computation of Expected and Actual Returns on Plan Assets

		Rs.
Return on Rs. 5,00,000 held for 12 months at 10.50%		52,500
Return on Rs. 1,42,000 for 6 months at 10.50%		7,455
Loss of interest on benefits paid for 4 months on Rs. 63,000 for 4 months @ 10.50%		(2,205)
Expected return on plan assets for 2023-2024		57,750
Fair value of plan assets as on 31st March 2024		7,50,000
Less: Fair value of plan assets as on 1 April,2023	5,00,000	
Contributions received on 30.9.2023	1,42,000	(6,42,000)
		1,08,000
Add: Benefits paid on 30th Nov 2023		63,000
Actual return on plan assets		1,71,000

Question 2: Synergy Ltd., is in engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of Rs. 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs. 2 lakhs instead of Rs. 5 lakhs. The average remaining life of the employee is estimated to be 6 years.

You are required to advise the company. (MTP Sept 24 S1 4M)

Answer:

According to AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of Rs. 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year. Hence, Synergy Ltd. cannot spread the actuarial gain of Rs. 6 lakhs over the next 2 years by reducing the annual contributions to Rs. 2 lakhs instead of Rs. 5 lakhs. It has to contribute Rs. 5 lakhs annually for its pension schemes.

AS – 16: Borrowing Costs

Illustrations

Illustration 1

PRM Ltd. obtained a loan from a bank for Rs.120 lakhs on 30-04-20X1. It was utilised as follows:

Particulars	Amount (Rs.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 20X2. The machinery was installed on the date of acquisition. Delivery of truck was not received. Total interest charged by the bank for the year ending 31-03-20X2 was Rs.18 lakhs. Show the treatment of interest.

Solution:

Qualifying Asset as per AS 16 = Rs.50 lakhs (construction of a shed)

Borrowing cost to be capitalised = 18 x 50/120 = Rs.7.5 lakhs

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

Illustration 2

X Ltd. began construction of a new building on 1st January, 20X1. It obtained Rs.1 lakh special loan to finance the construction of the building on 1st January, 20X1 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
Rs.5,00,000	11%
Rs.9,00,000	13%

The expenditures that were made on the building project were as follows:

		Rs.
January	20X1	2,00,000
April	20X1	2,50,000
July	20X1	4,50,000
December	20X1	1,20,000

Building was completed by 31st December 20X1. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalised and pass one Journal Entry for capitalising the cost and borrowing cost in respect of the building.

Solution:

(i) Computation of weighted average accumulated expenses

				Rs.
Rs.	2,00,000	x 12 / 12	=	2,00,000
Rs.	2,50,000	x 9 / 12	=	1,87,500
Rs.	4,50,000	x 6 / 12	=	2,25,000
Rs.	1,20,000	x 1 / 12	=	10,000
				6,22,500

(ii) Calculation of weighted average interest rate other than for specific borrowings

Amount of loan (Rs.)	Rate of interest	Amount of interest (Rs.)	
5,00,000	11%	=	55,000
9,00,000	13%	=	1,17,000
14,00,000			1,72,000
Weighted average rate of interest $\left(\frac{1,72,000}{14,00,000} \times 100\right)$		= 12.285% (approx.)	

(iii) Interest on weighted average accumulated expenses

		Rs.
Specific borrowings (Rs.1,00,000 x 10%)	=	10,000
Non-specific borrowings (Rs.5,22,500* x 12.285%)	=	64,189
Amount of interest to be capitalised	=	74,189

(iv) Total expenses to be capitalized for building

	Rs.
Cost of building Rs. (2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	74,189
	10,94,189

(v) Journal Entry

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
31.12. 20X1	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalised)			

Illustration 3

The company has obtained Institutional Term Loan of Rs.580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 20X2 amounted to Rs.406 lakhs, Rs.58 lakhs has been advanced to suppliers for additional assets and the balance loan of Rs.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 Rs.52.20 lakhs incurred during 20X1-20X2 on the entire Institutional Term Loan of Rs.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 capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

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 Rs.52.20 lakhs can be given as:

Purpose	Nature	Interest to be capitalised	Interest to be charged to profit and loss account

		Rs.in lakhs	Rs.in lakhs
Modernisation and renovation of plant and machinery	Qualifying asset	* *52.20 x 406 / 580 = 36.54	
		* *52.20 x 58 / 580 = 5.22	
Advance to supplies for additional assets	Qualifying asset		52.20 x 116 / 580 = 10.44
Working Capital	Not a qualifying asset		
		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 modernisation 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 assets. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assets 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, Rs.52.20 lakhs will be recognised as expense in the profit and loss account for year ended 31st March, 20X2.

Illustration 4

Take Ltd. has borrowed Rs.30 lakhs from State Bank of India during the financial year 20X1-20X2. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost Rs.50 lakhs. As on 31st March, 20X2, since the said project was not complete, the directors of Take Ltd. resolved to capitalise the interest accruing on borrowings amounting to Rs.4 lakhs and add it to the cost of investments. Comment.

Solution:

As per AS 13 (Revised) "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. Rs.4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 20X2.

Test Your Knowledge

1. **As per AS 16, all the following are qualifying assets except**
   - **(a)** Manufacturing plants and Power generation facilities
   - **(b)** Inventories that require substantial period of time
   - **(c)** Assets those are ready for sale.
   - **(d)** None of the above

2. **Which of the following statement is correct:**
   - **(a)** Entire exchange gain is reduced from the cost of the Qualifying asset.
   - **(b)** Entire exchange loss is added to the cost of a Qualifying asset.
   - **(c)** No adjustment is done for the exchange loss while computing cost of Qualifying asset.
   - **(d)** None of the above

3. **Capitalisation rate considers:**
   - **(a)** Borrowing costs on general borrowings only.
   - **(b)** Borrowing costs on general and specific borrowings both.
   - **(c)** Borrowing costs on specific borrowings only
   - **(d)** None of the above

4. **If the amount eligible for capitalisation in case of inventory as per AS 16 is Rs.12,000 and cost of inventory is Rs.40,000 and its net realizable value is Rs.45,000; What amount can be capitalised as a part of inventory cost.**
   - **(a)** Rs.12,000.
   - **(b)** Rs.5,000.
   - **(c)** Rs.7,000.
   - **(d)** Rs.10,000.

5. **X Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:**
   - **(i)** 15th May, 20X1: Loan interest relating to the project starts to be incurred
   - **(ii)** 2nd June, 20X1: Technical site planning commences
   - **(iii)** 19th June, 20X1: Expenditure on the project started to be incurred
   - **(iv)** 18th July, 20X1: Construction work commences

   Identify the commencement date for capitalisation under AS 16.
   - **(a)** 15th May, 20X1.
   - **(b)** 19th June, 20X1.
   - **(c)** 18th July, 20X1.
   - **(d)** 2nd June, 20X1

Answer to the Multiple Choice Questions

1.	(c)	2.	(c)	3.	(a)	4.	(b)	5.	(b)

Theoretical Questions

6. When capitalization of borrowing cost should cease as per Accounting Standard 16? Explain the provision.

Answer:

Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities 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.

7. H Ltd. incurs borrowing costs for the purpose of construction of a qualifying asset for its own use. The construction gets completed on May 31-20X1. However decoration work is under process which is expected to be completed by November 20X1 after which H Ltd. will be able to start using the said asset for its own use. H Ltd. wants to capitalize the eligible borrowing costs incurred up to November 20X1.

Answer:

The capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale is completed.

In the given case, H Ltd. should capitalize borrowing costs only up to May 31, 20X1. The borrowing cost incurred thereafter cannot be capitalized as the asset was ready for its intended use on May 31, 20X1. The fact that decoration work was being carried out should not be considered as the asset was ready for its intended use on May 31, 20X1.

8. ABC Ltd. is in the process of getting an entertainment park constructed. For this purpose, it has taken loan from a bank. The said park consists of several rides and facilities, each of which can be used individually. Three fourth part of the park has been constructed and can be opened up for public, while construction on the remaining part is continuing. Whether the capitalization of borrowing cost should continue for the whole park until construction continues?

Answer:

ABC Ltd. is in process of constructing an entertainment park which consists of several rides and facilities that can operate independently for their intended use. Even though the park as whole is not complete, the individual facilities are ready for their intended use.

The cessation of capitalization depends upon the nature of the qualifying assets, particularly where the qualifying assets consists of various parts. There are qualifying assets where each part is capable of being used while the construction continues on other parts. There are qualifying assets where all parts have to be completed before any earlier completed part can be put to use.

Since in the given scenario, the individual facilities are capable of operating independently and are ready for their intended use, therefore the borrowing costs shall cease to be capitalized for the three-fourth part of the project.

Scenario Based Questions

9. On 1st April, 20X1, Amazing Construction Ltd. obtained a loan of Rs.32 crores to be utilised as under:

(i)	Construction of sealink across two cities: (work was held up totally for a month during the year due to high water levels)		Rs.	25 crores
(ii)	Purchase of equipments and machineries	:	Rs.	3 crores
(iii)	Working capital	:	Rs.	2 crores
(iv)	Purchase of vehicles	:	Rs.	50,00,000
(v)	Advance for tools/cranes etc.	:	Rs.	50,00,000
(vi)	Purchase of technical know-how	:	Rs.	1 crores
(vii)	Total interest charged by the bank for the year ending 31st March, 20X2	:	Rs.	80,00,000

Show the treatment of interest by Amazing Construction Ltd.

Answer:

According to AS 16 'Borrowing costs', qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The treatment of interest by Amazing Construction Ltd. can be shown as:

	Qualifying Asset	Interest to be capitalised Rs.	Interest to be charged to Profit & Loss A/c Rs.	
Construction of sea-link	Yes	62,50,000		[80,00,000x(25/32)]
Purchase of equipment and machineries	No		7,50,000	[80,00,000x(3/32)]
Working capital	No		5,00,000	[80,00,000x(2/32)]
Purchase of vehicles	No		1,25,000	[80,00,000x(0.5/32)]
Advance for tools, cranes etc.	No		1,25,000	[80,00,000x(0.5/32)]
Purchase of technical know-how	No		2,50,000	[80,00,000x(1/32)]
Total		62,50,000	17,50,000	

*It is assumed that work held up for a month due to high water level is normal during the construction of sealink and capitalization of borrowing cost should not be suspended for necessary temporary delay.

10. Rainbow Limited borrowed an amount of Rs.150 crores on 1.4.20X1 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a. the accountant of Rainbow Ltd. capitalized Rs.19.50 crores for the accounting period ending on 31.3.20X2. Due to surplus fund out of Rs.150 crores income of Rs.3.50 crores were earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.

Answer:

Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings."

The capitalization 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.

Thus, the treatment of accountant of Rainbow Ltd. is incorrect.

Amount of borrowing costs capitalized should be calculated as follows:

Particulars	Rs.in crores
Actual interest for 20X1-20X2 (11% of Rs.150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 20X1-20X2	13.00

11. Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the building will be started as soon as they are completed.

Following is the detail of the work done on different phases of the building during the current year:

(Rs.in lakhs)

	Phase I	Phase II	Phase III	Phase IV
	Rs.	Rs.	Rs.	Rs.
Cash expenditure	10	30	25	30
Building purchased	24	34	30	38
Total expenditure	34	64	55	68
Total expenditure of all phases				221
Loan taken @ 15% at the beginning of the year				200

During mid of the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year.

Answer:

Computation of amount to be capitalized

No.	Particulars	Rs.
1.	Interest expense on loan Rs.2,00,00,000 at 15%	30,00,000
2.	Total cost of Phases I and II (Rs. 34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (Rs. 55,00,000 + Rs.68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate Loan amount = 30,00,000 / 2,21,00,000 × 98,00,000	13,30,317 (approx.)
7.	Interest on loan used for Phases III & IV, based on proportionate Loan amount = 30,00,000 / 2,21,00,000×1,23,00,000	16,69,683 (approx.)

Accounting treatment

For Phase I and Phase II

Since Phase I and Phase II have become operational at the mid of the year, half of the interest amount of Rs.6,65,158.50 (i.e. Rs.13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of Rs.6,65,158.50 (i.e. Rs.13,30,317/2) relating to Phase I and Phase II should be expensed during the year.

For Phase III and Phase IV

Interest of Rs.16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

12. Expert Limited issued 12% secured debentures of Rs.100 lakhs on 01.06.20X1. Money raised from debentures to be utilized as under:

Intended Purpose	Amount Rs.in lakhs
Construction of factory building	40
Working Capital	30
Purchase of Machinery	15
Purchase of Furniture	2
Purchase of truck	13

Additional Information:

(i) Interest on debentures for the Financial Year 20X1-20X2 was paid by the Company.

(ii) During the year, the company invested idle fund of Rs.5 lakhs (out of the money raised from debentures) in Bank's fixed deposit and earned interest of Rs.50,000.

(iii) In March, 20X2 construction of factory building was not completed (it is expected that it will take another 6 months).

(iv) In March 20X2, Machinery was installed and ready for its intended use.

(v) Furniture was put to use at the end of March 20X2.

(vi) Truck is going to be received in April, 20X2.

You are required to show the treatment of interest as per AS 16 in respect of borrowing cost for the year ended 31st March, 20X2 in the Books of Expert Limited.

Answer:

According to AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use. As per the Standard, 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. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognized as an expense in the period in which they are incurred. It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost = Rs.10,00,000 (100 lakhs x 12% x 10/12) – Rs.50,000 = Rs.9,50,000

Particulars	Nature of assets	Interest to be capitalized (Rs.)	Interest to be charged to Profit & Loss Account (Rs.)
Construction of factory building	Qualifying Asset	9,50,000x40/100 = Rs.3,80,000	NIL
Purchase of Machinery	Not a Qualifying Asset	NIL	9,50,000x15/100 = 1,42,500
Purchase of and furniture	Not a Qualifying Asset	NIL	9,50,000x2/100 =19,000
Purchase of truck	Not a Qualifying Asset	NIL	9,50,000x13/100 = 1,23,500
Working Capital	Not a Qualifying Asset	NIL	9,50,000x30/100 = Rs.2,85,000
Total		Rs.3,80,000	Rs.5,70,000

SHRESHTA
THE GREATEST OF ALL TIME

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: A company incorporated in June 2020, has setup a factory within a period of 8 months with borrowed funds. The construction period of the assets had reduced drastically due to usage of technical innovations by the company and the company is able to justify the reasons for the same. Whether interest on borrowings for the period prior to the date of setting up the factory should be capitalized although it has taken less than 12 months for the assets to get ready for use. You are required to comment on the necessary treatment with reference to AS 16. (MTP April 22)

Answer:

As per AS 16 'Borrowing Costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Further, the standard states that 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 jus tified 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 is considered.

It may be implied that there is a rebuttable presumption that a 12 months period constitutes substantial period of time.

Under present circumstances where construction period has reduced drastically due to technical innovation, the 12 months period should at best be looked at as a benchmark and not as a conclusive yardstick. It may so happen that an asset under normal circumstances may take more than 12 months to complete. However, an enterprise that completes the asset in 8 months should not be penalized for its efficiency by denying it interest capitalization and vice versa. The substantial period criteria ensures that enterprises do not spend a lot of time and effort capturing immaterial interest cost for purposes of capitalization.

Therefore, if the factory is constructed in 8 months then it shall be considered as a qualifying asset. The interest on borrowings for the same shall be capitalised although it has taken less than 12 months for the asset to get ready to use.

Question 2: ABC Limited has started construction of an asset on 1st December, 2021, which continues till 31st March, 2022 (and is expected to go beyond a year). The entity has not taken any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. The directly attributable expenditure at the beginning of the month on this asset was ₹ 10 lakh in December 2021 and ₹ 4 lakh in each of the months of January to March 2022. At the beginning of the year, the entity had taken Inter Corporate Deposits of ₹ 20 lakh at 9% rate of interest and had an overdraft of ₹ 4 lakh, which increased to ₹ 8 lakh on 1st March, 2022; Interest was paid on the overdraft at 10% until 1st January, 2022 and then the rate was increased to 12%. You are required to calculate the annual capitalization rate for computation of borrowing cost in accordance with AS 16 'Borrowing Costs'; (April 23)

Answer:

Calculation of capitalization rate on borrowings other than specific borrowings

Nature of general borrowings	Period of Outstanding balance	Amount of loan(Rs.)	Rate of interest p.a.	Weighted average amount of Interest (Rs.)

	a	b	c	d=[b x c)X(a/12)]
9% Debentures	12 months	20,00,000	9%	1,80,000
Bank overdraft	9 months	4,00,000	10%	30,000
	2 months	4,00,000	12%	8,000
	1 month	8,00,000	12%	8,000
		36,00,000		2,26,000

Weighted average cost of borrowings
=(20,00,000 x(12/12))+(4,00,000 x(11/12))+(8,00,000 x (1/12)} = 24,33,334
Capitalisation rate = [(Weighted average amount of interest / Weighted average of general borrowings) x 100] = [(2,26,000 / 24,33,334) x 100] = 9.29% p.a.

Question 3: Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over s everal years but Phase I and Phase II of the building will be started as soon as they are completed.
Following is the detail of the work done on different phases of the building during the current year: (₹ in lakhs)

	Phase I	Phase II	Phase III	Phase IV
	₹	₹	₹	₹
Cash expenditure	10	30	25	30
Building purchased	24	34	30	38
Total expenditure	34	64	55	68
Total expenditure of all phases				221
Loan taken @ 15% at the beginning of the year				200

During mid of the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year. (RTP Nov '22)

Answer:

	Particulars	₹
1.	Interest expense on loan ₹ 2,00,00,000 at 15%	30,00,000
2	Total cost of Phases I and II (₹ 34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (₹ 55,00,000 + ₹ 68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate Loan amount = 30,00,000 / 2,21,00,000 × 98,00,000	13,30,317 (approx.)
7.	Interest on loan used for Phases III & IV, based on proportionate Loan amount= 30,00,000 / 2,21,00,000 = × 1,23,00,000	16,69,683 (approx.)

Accounting treatment:

1. **For Phase I and Phase II**

Since Phase I and Phase II have become operational at the mid of the year, half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be expensed during the year.

2. For Phase III and Phase IV

Interest of ₹ 16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

Question 4: Expert Limited issued 12% secured debentures of ₹ 100 lakhs on 01;06;2021; Money raised from debentures to be utilized as under:

Intended Purpose	Amount ₹ in lakhs
Construction of factory building	40
Working Capital	30
Purchase of Machinery	15
Purchase of Furniture	2
Purchase of truck	13

Additional Information:

Interest on debentures for the Financial Year 2021-2022 was paid by the Company.

During the year, the company invested idle fund of ₹ 5 lakhs (out of the money raised from debentures) in Bank's fixed deposit and earned interest of ₹ 50,000;

In March, 2022 construction of factory building was not completed (it is expected that it will take another 6 months).

In March 2022, Machinery was installed and ready for its intended use. Furniture was put to use at the end of March 2022.

Truck is going to be received in April, 2022.

You are required to show the treatment of interest as per AS 16 in respect of borrowing cost for the year ended 31st March, 2022 in the Books of Expert Limited. (RTP May 23)

Answer:

According to AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use. As per the Standard, 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. The amount o f borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognized as an expense in the period in which they are incurred. It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost = ₹ 10,00,000 (100 lakhs x 12% x 10/12) – ₹ 50,000 = ₹ 9,50,000

Particulars	Nature of assets	Interest to be capitalized (₹)	Interest to be charged to Profit & Loss Account (₹)
Construction of factory building	Qualifying Asset	9,50,000x40/100 = ₹ 3,80,000	NIL
Purchase of Machinery	Not a Qualifying Asset	NIL	9,50,000x15/100 = 1,42,500

Purchase of and furniture	Not a Qualifying Asset	NIL	9,50,000x2/100 =19,000
Purchase of truck	Not a Qualifying Asset	NIL	9,50,000x13/100 = 1,23,500
Working Capital	Not a Qualifying Asset	NIL	9,50,000x30/100 = ₹ 2,85,000
Total		₹ 3,80,000	₹ 5,70,000

Question 5: Zebra Limited began construction of a new plant on 1st April,2021 and obtained a special loan of ₹20,00,000 to finance the construction of the plant. The rate of interest on loan was 10%. The expenditure that was incurred on the construction of plant was as follows:

	₹
1st April,2021	10,00,000
1st August,2021	24,00,000
1st January,2022	4,00,000

The company's other outstanding non-specific loan was ₹ 46,00,000 at an interest rate of 12%;

The construction of the plant completed on 31st March,2022. You are required to:

(a) Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".

(b) Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.

(PYP May'22)

Answer:

Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

	₹
Cost of Plant (10,00,000 + 24,00,000 + 4,00,000)	38,00,000
Add: Amount of interest to be capitalized (W.N.)	3,24,000
	41,24,000

Journal Entry

		₹	₹
31st March, 2022	Plant A/c Dr. To Bank A/c [Being amount of cost of plant and borrowing cost thereon capitalized]	41,24,000	41,24,000

Working Note:

Computation of interest to be capitalized:

	Expenditure			₹
1st April, 2021	10,00,000	On specific borrowing	₹ 10,00,000 x 10%	1,00,000
1st August, 2021	24,00,000	On specific borrowing	₹ 10,00,000 x 10%	1,00,000
1st August, 2021		On non-specific borrowings	₹ 14,00,000× 8 / 12 x 12%	1,12,000
1st January, 2022	4,00,000	On non-specific borrowings	₹ 4,00,000 × 8 / 13 ×12	12,000

				3,24,000

Alternatively, interest cost to be capitalized can be derived by computing average accumulated expenses in the following manner.

Computation of Average Accumulated Expenses:

1st April, 2021	10,00,000 x 12/12	10,00,000
1st August, 2021	10,00,000 x 12/12 14,00,000 x 8/12	10,00,000 9,33,333
1st January, 2022	4,00,000 x 3/12	1,00,000
		30,33,333

Computation of interest to be capitalized:

		₹
On specific borrowing	₹ 20,00,000 x 10%	2,00,000
On non-specific borrowing	₹ (30,33,333- 20,00,000) x 12%	1,24,000
		3,24,000

NOTE: Since specific borrowings are earmarked for construction of a particular qualifying asset, it cannot be used for construction of any other qualifying asset except for temporary investment. Therefore, once the commencement of capitalization of borrowing cost criteria are met, actual borrowing cost incurred on specific borrowing shall be capitalized irrespective of the fact that amount had been utilized in parts.

Question 6: On 1stApril, 2022 Workhouse Limited took a loan from a Financial Institution for ₹ 25,00,000 for the construction of Building. The rate of interest is 12%.
In addition to above loan, the company has taken multiple borrowings as follows:
i) 8% Debentures ₹ 15,00,000
ii) 15% Term Loan ₹ 30,00,000
iii) 10% Other Loans ₹ 18,00,000
The company has utilised the above funds in construction / purchase of the following assets:
(i) Building ₹ 70,00,000
(ii) Furniture ₹ 22,00,000
(iii) Plant & Machinery ₹ 90,00,000
(iv) Factory Shed ₹ 43,00,000
The construction of Building, Plant & Machinery and Factory Shed was completed on 31st March 2023. Readymade Furniture was purchased directly from the market. The factory was ready for production on 1stApril 2023.
You are required to calculate the borrowing cost for both qualifying and non-qualifying assets.
(PYP May '23)

Answer:

Interest to be Capitalized (on qualifying asset)

	Particulars	Computation	₹
i.	On specific Borrowings	25,00,000x12%	3,00,000
ii.	On non-specific borrowings	(W.N.1)	6,67,500
iii.	Amount of interest to be Capitalised	(i + ii)	9,67,500

Interest transferred to P&L (on non-qualifying asset)

	Particulars	Computation	₹
i.	On non-specific Borrowings	(W.N.1)	82,500

Working note:

1. Treatment of interest under AS 16 on non-specific borrowings

	Particulars	Qualifying asset	# Computation	Interest-Capitalized	Interest charged to P & L A/c
i.	Building	Yes	45,00,000/2,00,00,000 x 63,00,000 x 11.9048%	1,68,750	-
ii.	Furniture	No	22,00,000/2,00,00,000 x 63,00,000 x 11.9048%	-	82,500
iii.	Plant & Machinery	Yes	90,00,000/2,00,00,000 x 63,00,000 x 11.9048%	3,37,500	-
iv.	Factory shed	Yes	43,00,000/2,00,00,000 x 63,00,000 x 11.9048%	1,61,250	-
	Total			6,67,500	82,500

NOTE: Alternative manner of presentation for Treatment of interest under AS 16 on non-specific borrowings:

	Particulars Qualifying asset		Expenses Share in Incurred borrowings		Interest-Capitalized	Interest charged to P & L A/c
			₹	₹	₹	₹
i.	Building	Yes	45,00,000	7,50,000 x 45/200	1,68,750	-
ii.	Furniture	No	22,00,000	7,50,000 x 22/200	-	82,500
iii.	Plant & Machinery	Yes	90,00,000	7,50,000 x 90 /200	3,37,500	-
iv.	Factory shed	Yes	43,00,000	7,50,000 x 43 / 200	1,61,250	-
	Total		**2,00,00,000**		**6,67,500**	**82,500**

2. **Weighted Average interest rate for non-specific borrowings**

Particulars	Amount of loan (a)	Rate of interest (b)	Amount of interest (c) = (a) x (b)
Debentures	15,00,000	8%	1,20,000
Term loan	30,00,000	15%	4,50,000
Other loans	18,00,000	10%	1,80,000
	63,00,000		7,50,000
		# Weighted Average Rate of Interest = 7,50,000 / 63,00,000 x 100 = 11.9048%	

Question 7: On 1st April, 2023, Green Limited started the construction of an Office Building (qualified asset). The land under the building is regarded as a separate asset and is not a part of qualifying asset.

For the purpose of construction of building, the company raised a specific loan of Rs. 14 lakhs from a Bank at an interest rate of 12% per annum. An interest income of Rs. 15,000 was earned on this loan while it was held in anticipation of payments.

The company's other outstanding loans on 1stApril, 2023 were as follows:

Amount of Loan	Rate of Interest per annum
Rs. 20,00,000	15%
Rs. 30,00,000	8%

The construction of building started on 1stApril, 2023 and was completed on 31st January,

2024 when it was ready for its intended use. Up to the date of completion of the building, the following payments were made to the contractor:

Payment date	Amount in Rs.
1st Apirl,2023	4,00,000
1st August,2023	10,00,000
1st December,2023	25,00,000
31st January,2024	5,00,000

The life of building is estimated to be 20 years and depreciation is calculated on straight line method.

You are required to:

(i) Calculate the amount of borrowing cost to be capitalized.

(ii) Pass initial journal entry to recognise the cost of building.

(iii) Depreciation on building for the year ending 31st March, 2024.

(iv) Carrying value of building as on 31st March, 2024. (PYP May 24, MTP Sept 25 S1 7M)

Answer:

(i) Computation of borrowing cost to be capitalized for specific borrowings and general borrowings based on weighted average accumulated expenses

Date of incurrence of expenditure	Amount spent	Financed through	Calculation	Rs.
1st April 2023	4,00,000	Specific borrowing	4,00,000 x 12% x 10/12	40,000
1st August 2023	10,00,000	Specific borrowing	10,00,000 x 12% x 10/12	1,00,000
1st December 2023	25,00,000	General borrowing	25,00,000 x 10.8% x 2/12	45,000
31st January 2024	5,00,000	General borrowing	5,00,000 x 10.8% x 0/12	Nil
				1,85,000
Less: interest income on borrowing				(15,000)
Total amount borrowing cost to be capitalized				1,70,000

(ii) Journal Entry

Date	Particulars	Rs.	
31.1.2024	Building account Dr.	45,70,000	
	To Bank account		44,00,000
	To Interest payable (borrowing cost)		1,70,000
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)		

Note: In the above journal entry, it is assumed that interest amount will be paid at the year end. Hence, entry for interest payable has been passed on 31.1.2024.

Alternatively, following journal entry may be passed if interest is paid on the date of capitalization:

Date	Particulars	Rs.	Rs.
31.1.2024	Building account Dr.	45,70,000	
	To Bank account		45,70,000
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)		

(iii) Depreciation on building for the year ending 31.3.2024

Cost of building 45,70,000

Life of building = 20 years

Depreciation = (45,70,000/20) x 2/12 = 38,083.33

(iv) Carrying Value of Building on 31st March 2024:

Carrying Value = Cost of Building - Accumulated Depreciation

= 45,70,000- 38,083.33

= 45,31,917

Working Notes:

1. Calculation of capitalization rate on borrowings other than specific borrowings

Amount of loan (Rs.)	Rate of interest		Amount of interest (Rs.)
20,00,000	15%	=	3,00,000
30,00,000	8%	=	2,40,000
50,00,000			5,40,000
Weighted average rate of interest (5,40,000 / 50,00,000× 100)	=		10.8%*

2. Total expenses to be capitalized for building

	Rs.
Cost of building Rs. (4,00,000 + 10,00,000 + 25,00,000 + 5,00,000)	44,00,000
Add: Amount of interest to be capitalized	1,70,000
	45,70,000

Question 8: A company incorporated in June 2023, has setup a factory within a period of 8 months with borrowed funds. The construction period of the assets had reduced drastically due to usage of technical innovations by the company and the company is able to justify the reasons for the same. Whether interest on borrowings for the period prior to the date of setting up the factory should be capitalized although it has taken less than 12 months for the assets to get ready for use. You are required to comment on the necessary treatment with reference to AS 16. (MTP Sept 24 S2 4M)

Answer:

As per AS 16 'Borrowing Costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Further, the standard states that 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 is considered.

It may be implied that there is a rebuttable presumption that a 12 months period constitutes substantial period of time.

Under present circumstances where construction period has reduced drastically due to technical innovation, the 12 months period should at best be looked at as a benchmark and not as a conclusive yardstick. It may so happen that an asset under normal circumstances may take more than 12 months to complete. However, an enterprise that completes the asset in 8 months should not be penalized for its efficiency by denying it interest capitalization and vice versa.

The substantial period criteria ensures that enterprises do not spend a lot of time and effort capturing immaterial interest cost for purposes of capitalization.

Therefore, if the factory is constructed in 8 months then it shall be considered as a qualifying asset. The interest on borrowings for the same shall be capitalised although it has taken less than 12 months for the asset to get ready to use.

Question 9: How will interest be capitalised when qualifying assets are funded by borrowings in the nature of bonds that are issued at a discount? (MTP Sept 25 S2 5 Marks)

Answer:

As per AS 16, "Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds". Further, the Statement contemplates "amortisation of discounts or premiums relating to borrowings" as a component of borrowing costs (paragraph 4(b)). Thus, the borrowing costs comprise the periodic interest payable on the bonds in question and the amount of discount amortised during the period.

Paragraph 6 of the Statement, inter-alia, states that "Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset". Further, paragraph 19 states that "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". Thus, only that portion of the amortised discount should be capitalised as part of the cost of a qualifying asset which relates to the period during which acquisition, construction or production of the asset takes place.

Question 10: 16. Is it permissible to capitalise borrowing costs incurred on assets which are necessary for the construction of qualifying assets? A company is in the process of constructing a large manufacturing plant in a backward area. As a part of this project it has also purchased a residential building which is to be used for housing the workers engaged in the construction of the plant. The purchase cost of the building is met by raising a long term loan. The company intends to dispose off the building once the construction of the manufacturing plant is complete. If the manufacturing plant meets the definition of a qualifying asset would the borrowing costs incurred on funds borrowed to purchase the residential building be eligible for capitalisation? (RTP Sept 25)

Answer:

As per para 3 of AS 16 "Borrowing Costs" a qualifying asset as "an asset that necessarily takes a substantial period of time to get ready for its intended use or sale". Further, para 5 of the AS explains that "Assets that are ready for their intended use or sale when acquired also are not qualifying assets". In the given case, prima facie, it may appear that the residential building is ready for use when acquired, and thus, borrowing costs incurred on purchase ofresidential building should not be capitalised. However, since in the present case provision of housing facilities is necessary for the construction of the plant, the borrowing costs incurred are, in substance, directly attributable to the construction of the manufacturing plant. Accordingly, the company should capitalise, as a part of the cost of the manufacturing plant, borrowing costs incurred on funds borrowed to acquire the residential building upto the period the manufacturing plant is ready for its intended use.

AS – 17: Segment Reporting

Illustrations

Illustration 1

The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:

Rs. in lakhs

Particulars	M	N	O	P	Q	R	Total
Segment Assets	40	80	30	20	20	10	200
Segment Results	50	(190)	10	10	(10)	30	(100)
Segment Revenue	300	620	80	60	80	60	1,200

The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

Solution:

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

Its segment result whether profit or loss is 10% or more of:

- The combined result of all segments in profit; or
- The combined result of all segments in loss, whichever is greater in absolute amount; or

Its segment assets are 10% or more of the total assets of all segments.

If the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until atleast 75% of total enterprise revenue is included in reportable segments.

On the basis of turnover criteria segments M and N are reportable segments.

On the basis of the result criteria, segments M, N and R are reportable segments (since their results in absolute amount is 10% or more ofRs. 200 lakhs).

On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in at least one of the above criteria, all segments have to be reported in accordance with Accounting Standard (AS) 17. Hence the opinion of chief accountant is wrong.

Illustration 2

A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?

Solution:

AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers.

The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence the enterprise can have its own policy for pricing inter-segment transfers and hence inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Illustration 3

M/s XYZ Ltd. has three segments namely X, Y, Z. The total Assets of the Company are Rs. 10.00 crores. Segment X hasRs. 2.00 crores, segment Y has Rs. 3.00 crores and segment Z hasRs. 5.00 crores. Deferred tax assets included in the assets of each segments are X- Rs. 0.50 crores, Y—Rs. 0.40 crores and Z—Rs. 0.30 crores. The accountant contends that all the three segments are reportable segments. Comment.

Solution:

According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are Rs. 8.8 crores [Rs. 10 crores – (Rs. 0.5 + Rs. 0.4 +Rs. 0.3)]. Segment X holds total assets of Rs. 1.5 crores (Rs. 2 crores –Rs. 0.5 crores); Segment Y holds Rs. 2.6 crores (Rs. 3 crores –Rs. 0.4 crores); and Segment Z holds Rs. 4.7 crores (Rs. 5 crores –Rs. 0.3 crores). Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Illustration 4

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

	Rs. ('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 Rs. ('000)	Forging Shop Division Rs. ('000)	Bright Bar Division Rs. ('000)	Fitting Division Rs. ('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

(Rs. '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

(Rs. '000)

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

Illustration 5

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

Solution:

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".

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Test Your Knowledge

1. **As per AS 17, reportable segments are those whose total revenue from external sales and inter-segment sales is**
   - **(a)** 10% or more of the total revenue of all segments
   - **(b)** 10% or more of the total revenue of all external segments
   - **(c)** 12% or more of the total revenue of all segments
   - **(d)** 12% or more of the total revenue of all external segments

2. **Which of the following statements is correct?**
   - **(a)** Management has a discretion to include a segment as a reportable segment even if it passes the 10% materiality test.
   - **(b)** Management has a discretion to include any segment as a reportable segment if it fails the 12% materiality test.
   - **(c)** It is mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.
   - **(d)** It is not mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.

3. **Which of the following statements is correct?**
   - **(a)** The overall test of 75% considers only external revenue to compute the threshold limit.
   - **(b)** The overall test of 75% considers only internal revenue to compute the threshold limit.
   - **(c)** The overall test of 75% considers both internal and external revenue to compute the threshold limit.
   - **(d)** It is management choice whether they want to include both external and internal revenue for computing threshold limit.

4. **Which of the following statements is correct?**
   - **(a)** The 10% test computed on the basis of revenue, considers both internal and external revenue to compute the threshold limit.
   - **(b)** The 10% test computed on the basis of revenue, considers only external revenue to compute the threshold limit.
   - **(c)** The 10% test computed on the basis of revenue, considers only internal revenue to compute the threshold limit.
   - **(d)** It is management choice whether they want to include both external and internal revenue for computing threshold limit.

5. **Which of the following statements is correct?**
   - **(a)** In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or net loss respectively of all segments taken together becomes reportable segment.
   - **(b)** In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit (after netting the losses) of all segments taken together becomes reportable segment.
   - **(c)** In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or loss (whichever is higher in absolute figures) of all segments taken together becomes reportable segment.
   - **(d)** In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or loss (whichever is lower in absolute figures) of all segments taken together becomes reportable segment.

Answers to the Multiple Choice Questions

1.	(a)	2.	(c)	3.	(a)	4.	(a)	5.	(c)

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Scenario Based Question

6. Nathan Limited has three segments namely P, Q and R. The assets of the company are Rs. 15 crores. Segment P has 4 crores, Segment Q has 6 crores and Segment R has 5 crores. Deferred tax assets included in the assets of each segment are P - Rs. 1 crore, Q - Rs. 0.90 crores and R - Rs. 0.80 crores. The accountant contends all these three segments are reportable segments. Comment.

Answer:

According to AS 17 "Segment Reporting", segment assets do not include income tax assets.

Therefore, the revised total assets are 12.3 crores [Rs. 15 - (Rs. 1 +0.9 + 0.8).

Details of Segment wise assets:

Segment P holds total assets of Rs. 3 crores (Rs. 4 crores - Rs. 1 crores);

Segment Q holds Rs. 5.1 crores (Rs. 6 crores - Rs. 0.9 crores);

Segment R holds Rs. 4.2 crores (Rs. 5 crores - Rs. 0.8 crores).

Thus, all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Hence, the contention of the Accountant that all three segments are reportable segments is correct.

7. Company A is engaged in the manufacture and sale of products, which constitute two distinct business segments. The products of the Company are sold in the domestic market only. The management information system of the Company is organized to reflect operating information by two broad market segments, rural and urban.

Besides the two business segments, how should Company A identify geographical segments? Do geographical segments exist within the same country? Explain in line with the provisions of AS 17.

Answer:

AS 17 explains that, "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".

Accordingly, to identity geographical segments, Company A needs to evaluate whether the segments reflected in the management information system function in environments that are subject to significantly differing risks and returns irrespective of the fact whether they are within the same country.

The Standard recognizes that, "Determining the composition of a business or geographical segment involves a certain amount of judgement…".

Accordingly, while the management information system of the Company provides segment information for rural and urban geographical segments for the purpose of internal reporting, judgement is required to determine whether these segments are subject to significantly differing risks and returns based on the definition of geographical segment. In making such a judgement, aspect like different pricing and other policies, e.g., credit policies, deployment of resources between different regions etc., may be considered for the purpose identifying 'urban and 'rural' as separate geographical segment.

Company A, in making judgment for identifying geographical segments, should also consider the relevance, reliability and comparability over time of segment information that will be reported. The Standard, explains that, "In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in the standard and the qualitative characteristics of financial statements. The qualitative characteristics include the relevance, reliability

and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise."

8. PK Ltd. has identified business segment as its primary reporting format. It has identified India, USA and UK as three geographical segments. It sells its products in the Indian market, which constitutes 70 percent of the Company's sales. 25 per cent is sold in USA and the balance is sold in UK.
Is PK Ltd. as part of its geographical secondary segment information, required to disclose segment revenue from export sales, where such sales are not significant?

Answer:

As per AS 17, if primary format of an enterprise for reporting segment information is business segments, it should also report 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.

Therefore, for the purposes of disclosing secondary segment information, PK Ltd. is not required to disclose segment revenue from export sales to UK, since that segment does not meet the 10 per cent or more of enterprise revenue threshold.

However, other secondary segment information as per AS 17 should be disclosed in respect of this segment if the thresholds prescribed in the AS 17 are met.

9. XYZ Ltd. has 5 business segments. Profit / Loss of each of the segments for the year ended 31st March, 20X2 have been provided below. You are required to identify from the following whether reportable segments or not reportable segments, on the basis of "profitability test" as per AS-17.

Segment	Profit (Loss) Rs. in lakhs
A	225
B	25
C	(175)
D	(20)
E	(105)

Answer:

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

Its segment results whether profit or loss is 10% or more of:

- The combined result of all segments in profit; i.e. Rs. 250 Lakhs or
- The combined result of all segments in loss; i.e. Rs. 300 Lakhs

Whichever is greater in absolute amount i.e. Rs. 300 Lakhs.

Operating Segment	Absolute amount of Profit or Loss (Rs. In lakhs)	Reportable Segment Yes or No
A	225	Yes
B	25	No
C	175	Yes
D	20	No
E	105	Yes

On the basis of the profitability test (result criteria), segments A, C and E are reportable segments (since their results in absolute amount is 10% or more ofRs. 300 lakhs i.e. 30 lakhs).

10. ABC Limited has 5 segments namely A, B, C, D and E. The profit/loss of each segment for the year ended March 31st, 20X2 is as follows:

Segment	Profit/(Loss) (Rs. in crore)
A	780
B	1,500
C	(2,300)
D	(4,500)
E	6,000
Total	1,480

Identify the Reportable segments.

Answer:

In compliance with AS 17, the segment profit/loss of respective segment will be compared with the greater of the following:

(i) All segments in profit, i.e., A, B and E - Total profit Rs. 8,280 crores.

(ii) All segments in loss, i.e., C and D - Total loss ₹ 6,800 crores.

Greater of the above - Rs. 8,280 crores.

Based on the above, reportable segments will be determined as follows:

Segment	Profit/(Loss)	Absolute Profit/Loss as a % of 8,280	Reportable Segment
A	780	9%	No
B	1,500	18%	Yes
C	(2,300)	28%	Yes
D	(4,500)	54%	Yes
E	6,000	72%	Yes
Total	**1,480**		

11. Heavy Goods Ltd. has 6 segments namely L-Q (below).

The total revenues (internal and external), profits or losses and assets are set out below:

(In Rs.)

Segment	Inter Segment Sales	External Sales	Profit / loss	Total assets
L	4,200	12,300	3,000	37,500
M	3,500	7,750	1,500	23,250
N	1,000	3,500	(1,500)	15,750
O	0	5,250	(750)	10,500
P	500	5,500	900	10,500
Q	1,200	1,050	600	5,250
	10,400	35,350	3,750	1,02,750

Heavy Goods Ltd. needs to determine how many reportable segments it has. You are required to advice Heavy Goods Ltd. as per the criteria defined in AS 17.

Answer:

Quantitative Threshold Test:

Revenue Test:

Combined total sales of all the segment = Rs. 10,400 + Rs. 35,350 = Rs. 45,750.

10% thresholds = 45,750 x 10% = 4,575.

Profitability Test:

In the given situation, combined reported profit = Rs. 6,000 and combined reported loss (Rs. 2,250).

Hence, for 10% thresholds Rs. 6,000 will be considered.

10% thresholds = Rs. 6,000 x 10% = Rs. 600

Asset Test:

Combined total assets of all the segment = Rs. 1,02,750

10% thresholds = Rs. 1,02,750 x 10% = 10,275

Accordingly, quantitative thresholds are calculated below:

Segments	L	M	N	O	P	Q	Reportable segments
% segment sales to total sales	36.66%	24.59%	9.84%	11.48%	13.11%	4.92%	L, M, O, P
% segment profit to total profits	50%	25%	25%	12.5%	15%	10%	L, M, N, O, P, Q
% segment assets to total assets	36.50%	22.63%	15.33%	10.22%	10.22%	5.11%	L, M, N, O, P

Conclusion:

Segments L, M, O and P clearly satisfy the revenue and assets tests and they are separate reportable segments.

Segment N does not satisfy the revenue test, but it does satisfy the asset test and it is a reportable segment.

Segment Q does not satisfy the revenue or the assets test but is does satisfy the profits test. Therefore, Segment Q is also a reportable segment.

Hence all segments i.e. L, M, N, O, P and Q are reportable segments.

12. Calculate the segment results of a manufacturing organization from the following information:

Segments	A	B	C	Total
Directly attributed revenue	5,00,000	3,00,000	1,00,000	9,00,000
Enterprise revenue				1,10,000
(allocated in 5 :4 : 2 basis)				
Revenue from transactions with other segments				
Transaction from B	1,00,000		50,000	1,50,000
Transaction from C	10,000	50,000		60,000
Transaction from A		25,000	1,00,000	1,25,000
Operating expenses	3,00,000	1,50,000	75,000	5,25,000
Enterprise expenses (allocated in 5 :4 :2 basis)				77,000
Expenses on transactions with other segments				
Transaction from B	75,000		30,000	
Transaction from C	6,000	40,000		

	Transaction from A		**18,000**	**82,000**	

Answer:

Computation of segment result:

Segments	**A** **Rs.**	**B** **Rs.**	**C** **Rs.**	**Total** **Rs.**
Directly attributed revenue	5,00,000	3,00,000	1,00,000	9,00,000
Enterprise revenue (allocated in 5 :4 :2 basis)	50,000	40,000	20,000	1,10,000
Revenue from transactions with other segments				
Transaction from B	1,00,000		50,000	1,50,000
Transaction from C	10,000	50,000		60,000
Transaction from A		25,000	1,00,000	1,25,000
Total segment revenue (1)	**6,60,000**	**4,15,000**	**2.70,000**	**13,45,000**
Operating expenses	3,00,000	1,50,000	75,000	5,25,000
Enterprise expenses (allocated in 5 :4 :2 basis)	35,000	28,000	14,000	77,000
Expenses on transactions with other segments				
Transaction from B	75,000		30,000	1,05,000
Transaction from C	6,000	40,000		46,000
Transaction from A		18,000	82,000	1,00,000
Total segment expenses (2)	**4,16,000**	**2,36,000**	**2,01,000**	**8,53,000**
Segment result (1-2)	**2,44,000**	**1,79,000**	**69,000**	**4,92,000**

13. The Senior Accountant of AMF Ltd. gives the following data regarding its five segments:

(Rs. in lakhs)

Particulars	**P**	**Q**	**R**	**S**	**T**	**Total**
	(Rs.)	**(Rs.)**	**(Rs.)**	**(Rs.)**	**(Rs.)**	**(Rs.)**
Segment Assets	**80**	**30**	**20**	**20**	**10**	**160**
Segment Results	**(190)**	**10**	**10**	**(10)**	**30**	**(150)**
Segment Revenue	**620**	**80**	**60**	**80**	**60**	**900**

The Senior Accountant is of the opinion that segment "P" alone should be reported. Is he justified in his view? Examine his opinion in the light of provision of AS-17 'Segment Reporting'.

Answer:

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

(i) Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

(ii) Its segment result whether profit or loss is 10% or more of:

(1) The combined result of all segments in profit; or

(2) The combined result of all segments in loss, whichever is greater in absolute amount; or

(iii) Its segment assets are 10% or more of the total assets of all segments.

Accordingly,

(a) On the basis of revenue from sales criteria, segment P is a reportable segment.

(b) On the basis of the result criteria, segments P & T are reportable segments (since their results in absolute amount is 10% or more of Rs. 200 Lakhs).

(c) On the basis of asset criteria, all segments except T are reportable segments.

Since all the segments are covered in at least one of the above criteria, all segments have to be reported upon in accordance with AS 17. Hence, the opinion of chief accountant that only segment 'P' is reportable is wrong.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: A Company has an inter-segment transfer pricing policy of charging at cost less 5%. The market prices are generally 20% above cost. You are required to examine whether the policy adopted by the company is correct or not? (MTP April '23) (RTP May'22, Nov'22)

Answer:

AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter- segment transfers and any change therein should be disclosed in the financial statements. Hence, the enterprise can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if followed consistently.

Question 2: The Chief Accountant of Cotton Garments Limited gives the following data regarding its five segments:

(₹ in Crore)

Particulars	A	B	C	D	E	Total
Segment Assets	40	15	10	10	5	80
Segment Results	(95)	5	5	(5)	15	(75)
Segment Revenue	310	40	30	40	30	450

The Chief Accountant is of the opinion that segment "A" alone should be reported. Is he justified in his view? Examine his opinion in the light of provisions of AS 17 'Segment Reporting'. (RTP Sept 25)

Answer:

As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

(i) Its **revenue** from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

(ii) Its segment **result** whether profit or loss is 10% or more of:

(1) The combined result of all segments in profit; or

(2) The combined result of all segments in loss,

whichever is greater in absolute amount; or

(iii) Its segment **assets** are 10% or more of the total assets of all segments.

Further, if the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until at least 75% of total enterprise revenue is included in reportable segments.

Accordingly,

(a) On the basis of **revenue from sales** criteria, segment A is a reportable segment.

(b) On the basis of the **result** criteria, segments A & E are reportable segments (since their results in absolute amount is 10% or more of ₹ 100 crore).

(c) On the basis of **asset** criteria, all segments except E are reportable segments.

Since all the segments are covered in atleast one of the above criteria, all segments have to be reported upon in accordance with AS 17.

Hence, the opinion of chief accountant that only segment 'A' is reportable is wrong.

AS – 18: Related Party Disclosures

Illustrations

Illustration 1

Identify the related parties in the following case 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:

In relation to Reporting enterprise - A Ltd.

- B Ltd. (subsidiary) is a related party
- O Ltd.(subsidiary) is a related party

In relation to Reporting enterprise - B Ltd.

- A Ltd. (holding company) is a related party
- O Ltd. (subsidiary) is a related party

In relation to Reporting enterprise - O Ltd.

- A Ltd. (ultimate holding company) is a related party
- B Ltd. (holding company) is a related party
- Z Ltd. (investor/ investing party) is a related party (O Ltd being Associate of Z Ltd)

Reporting enterprise - Z Ltd.

- O Ltd. (Associate) is a related party

Illustration 2

Consider a scenario wherein:

- **A Ltd. has 60% voting right in B Ltd.**
- **A Ltd. also has 22% voting right in C Ltd.; and**
- **B Ltd. has 30% voting right in C Ltd.**

Whether C Ltd. is to be treated under AS-18 as a party related to A Ltd.?

Solution:

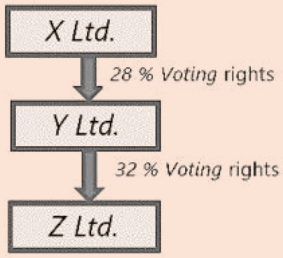
Yes – in relation to A Ltd. (the reporting enterprise), C Ltd. is a related party under AS-18. This is because A Ltd. indirectly controls C Ltd.

In this case, A Ltd. (together with its subsidiary B Ltd.) controls more than one half of the voting rights of C Ltd.

Illustration 3

Consider a scenario wherein:

- **X Ltd. holds 28% voting right in Y Ltd. (and hence Y Ltd. is an associate of X Ltd.)**
- **Y Ltd. holds 32% voting right in Z Ltd. (and hence Z Ltd. is an associate of Y Ltd.)**



In the above case, since Y Ltd. is an associate of X Ltd. – Y Ltd. is a related party to X Ltd.
Likewise, since Z Ltd. is an associate of Y Ltd. - Z Ltd. is a related party to Y Ltd.
The question is: Whether Z Ltd. is to be treated under AS-18 as a party related to X Ltd.?

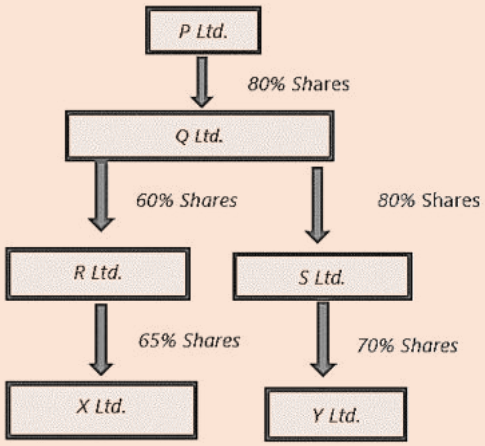
Solution:

No – in relation to X Ltd. (the reporting enterprise), Z Ltd. is a **not** a related party.

This is because as per the requirements of AS-18, 'associate of an associate' is **not** a related party.

Illustration 4

Consider the following organization structure related to P Ltd.



Given the above structure: Identify related party relationships, if R Ltd. is the reporting enterprise

Solution:

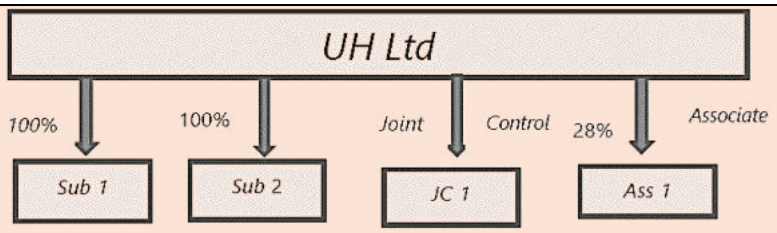
The following table identifies the related party relationships for R Ltd. (being the reporting enterprise):

Party Name	Relationship under AS-18
P Ltd.	♦ P Ltd. has indirect control on R Ltd. (through Q Ltd.) ♦ Hence R Ltd. is related to P Ltd.
Q Ltd.	♦ Q Ltd. has direct control of R Ltd. ♦ Hence R Ltd. is related to Q Ltd.
S Ltd.	♦ R Ltd. and S Ltd. are under common control of Q Ltd. ♦ Hence R Ltd. is related to S Ltd.
X Ltd.	♦ X Ltd. is controlled by R Ltd. ♦ Hence R Ltd. is related to X Ltd.
Y Ltd.	♦ Y Ltd. is the sub-subsidiary of Q Ltd. ♦ Both R Ltd. and Y Ltd. are under common control of Q Ltd. ♦ Hence R Ltd. is related to Y Ltd.

Illustration 5

Consider the following organization structure related to UH Ltd. (the ultimate parent company of a Group), wherein UH Ltd. has made the following investments:

- **Investment in two of the wholly owned subsidiaries, viz. Sub 1 and Sub 2**
- **Investment in JC 1, in which UH Ltd. has a joint control**
- **20% investment in Ass 1 (and hence, Ass 1 is an associate of UH Ltd.)**



Given the above structure: Identify related party relationships for each of the above entities under AS-18.

Solution:

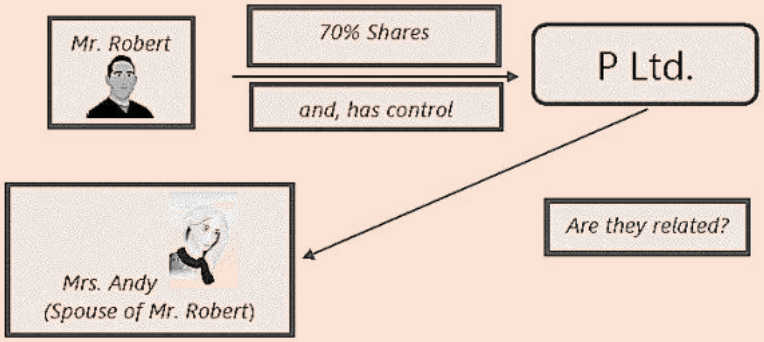
The following table identifies the related party relationships for each of the entities in the Group:

Reporting enterprise	Related Party as per AS-18
UH Ltd.	All the four entities (viz. Sub 1, Sub 2, JC 1 and Ass 1)
Sub 1	Only two of the entities in the Group (viz. UH Ltd. and Sub 2)
Sub 2	Only two of the entities in the Group (viz. UH Ltd. and Sub 1)
JC 1	Only UH Ltd.
Ass 1	Only UH Ltd.

Illustration 6

Consider a scenario wherein:

- **Mr. Robert holds 70% shares and voting rights in P Ltd**



Determine: Whether Andy (spouse of Mr. Robert) is a related party to P Ltd. under AS-18?

Solution:

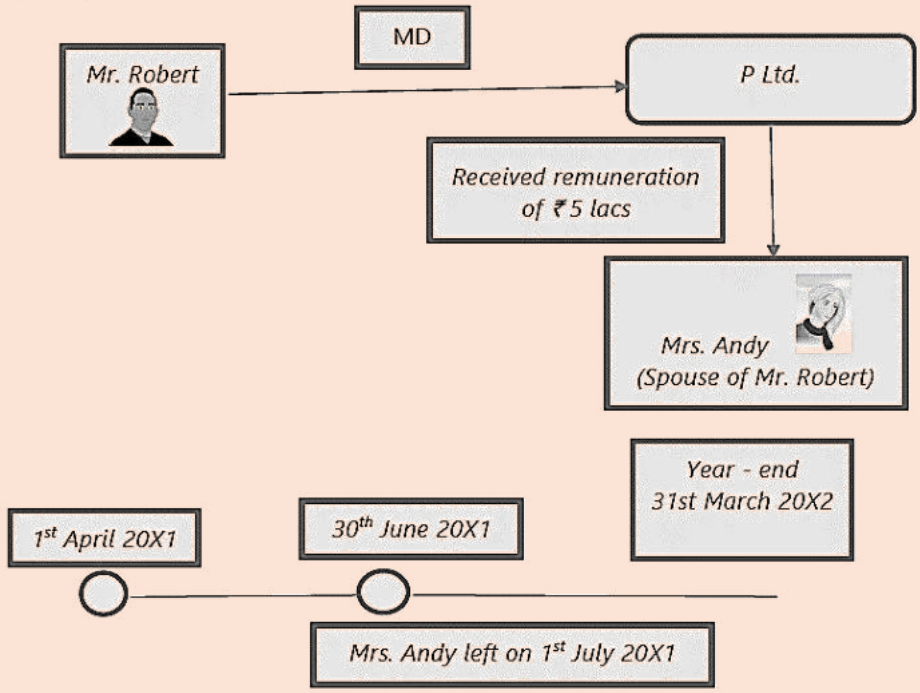
Yes – Andy is a related party to P Ltd., in view of the requirements of AS-18.

It may be recalled that under AS-18 'relatives of individuals owning an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise' are considered as related parties.

Illustration 7

Consider a scenario wherein:

- **Mr. Robert is a Managing Director of P Ltd.**
- **Andy (spouse of Robert) received a remuneration of Rs 5 lacs from P Ltd. – for the services she rendered to P Ltd. for the period 1st April 20X1 through 30th June 20X1**
- **Andy left the services of P Ltd. on 1st July 20X1**
- **Consider 31st March 20X2 as the year-end date for P Ltd.**



Whether Andy is to be identified as related party at the year-end date (31st March 20X2) for the purposes of AS-18?

Solution:

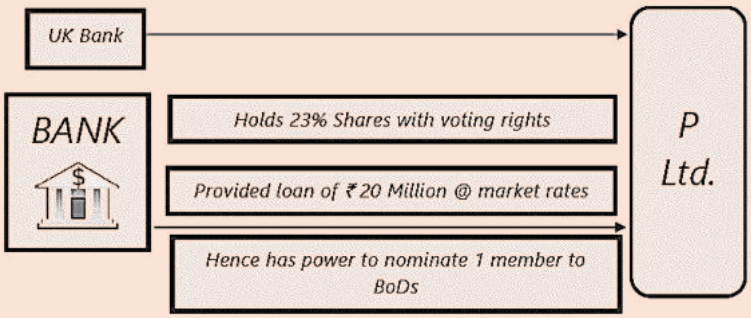
Yes – This is because as per AS-18, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Hence Andy (being the spouse and relative of the KMP of P Ltd.) **needs to be reported** as related party at the year-end date (i.e. 31st March 20X2). This is because the remuneration Andy received from P Ltd. (for the period April 20X1 to 30 June 20X1) falls within the reporting year April 20X1 to March 20X2.

Illustration 8

Consider a scenario wherein:

- **UK Bank holds 23% equity shares with voting rights in P Ltd.**
- **The bank has provided a loan of Rs. 20 million to P Ltd. at market interest rate**
- **As per the terms and conditions of the loan agreement, the bank has appointed one person as its nominee to the board of directors of P Ltd. and any major transaction to be entered into by P Ltd. will require the consent of the Bank**



Determine: Whether under AS-18 - UK Bank is a related party to P Ltd. (the reporting enterprise)?

Solution:

In the instant case, the UK Bank holds 23% shares with voting rights in P Ltd. and hence is deemed to exercise significant influence over P Ltd.

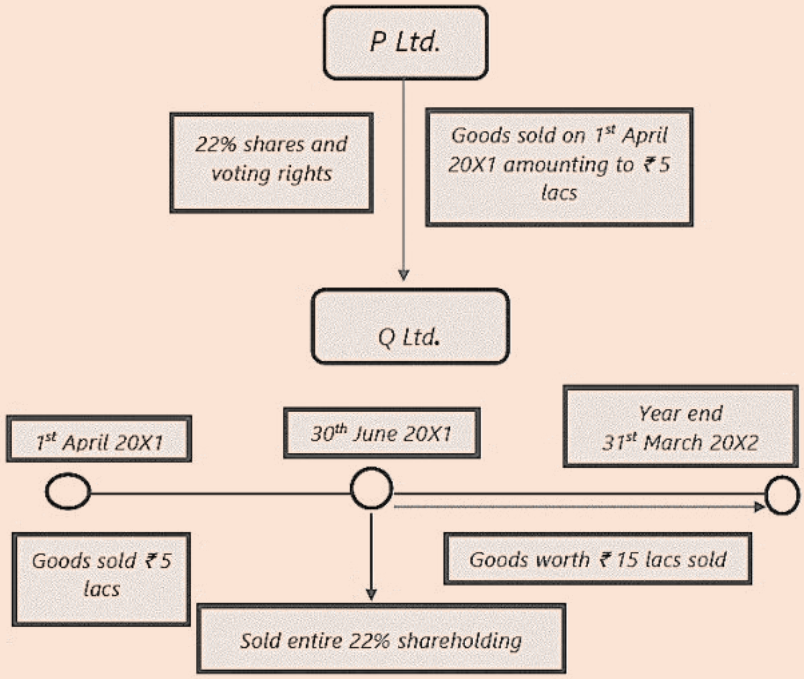
The bank is also a provider of finance to P Ltd. (the reporting enterprise) and as per AS-18, parties like providers of finance are deemed **not to be considered** as a related party in the course of normal dealings with an enterprise by virtue **only of those dealings.** However, this exemption will not be available to UK Bank in this case – since it exercises significant influence over P Ltd. (by virtue of holding 23% shares with voting rights in P Ltd.)

Accordingly, for P Ltd. (the reporting enterprise), the UK Bank is a related party and it will be required to disclose the transactions with UK Bank in its financial statements.

Illustration 9

Consider a scenario wherein:

- **P Ltd. hold 22% shares and voting rights in Q Ltd. (and hence Q Ltd. is an associate of P Ltd.)**
- **On 1st April 20X1, P Ltd. sold certain goods to Q Ltd. amounting to Rs. 5 lacs**
- **On 30th June 20X1, P Ltd. sold its entire 22% stake in Q Ltd. (and hence the related party relationship ceased to exist after 30th June 20X1)**
- **However, P Ltd. continued supply goods to Q Ltd. subsequent to 30th June 20X1 (just like any other customer) and sold goods worth Rs. 15 lacs during 9 -month period ended 31st March 20X2**
- **Consider 31st March 20X2 as the year-end date for P Ltd.**



Determine whether the transaction for the entire year (ending on 31st March 20X2) is required to be disclosed under AS-18 as related party transaction.

Solution:

No – This is because as per AS-18, the disclosure requirements under the Standard relate only to the period **during related party relationship existed.**

Accordingly, only transactions between P Ltd and Q Ltd till 30th June 20X1 (being sale of goods worth Rs. 5 lacs) are required to be reported / disclosed under AS-18.

Transactions entered into after 30th June 20X1 are **NOT required** to be disclosed under AS-18.

Illustration 10

Narmada Ltd. sold goods for Rs.90 lakhs to Ganga Ltd. during financial year ended 31-3-20X1. The Managing Director of Narmada Ltd. owns 100% shares of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices 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 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 and 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**.

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Test Your Knowledge

1. **According to AS-18 Related Party Disclosures, which ONE of the following is not a related party of Skyline Limited?**
   (a) A shareholder of Skyline Limited owning 30% of the ordinary share capital
   (b) An entity providing banking facilities to Skyline Limited in the normal course of business
   (c) An associate of Skyline Limited
   (d) Key management personnel of Skyline Limited

2. **Are the following statements in relation to related parties true or false, according to AS-18 Related Party Disclosures?**
   (A) A party is related to another entity that it is jointly controlled by.
   (B) A party is related to another entity that it controls.

	Statement (A)	Statement (B)
(a)	False	False
(b)	False	True
(c)	True	False
(d)	True	True

3. **Which of the following is <u>not</u> a related party as envisaged by AS-18 Related Party Disclosures?**
   (a) A director of the entity
   (b) The parent company of the entity
   (c) A shareholder of the entity that holds 1% stake in the entity
   (d) The spouse of the managing director of the entity

4. **According to AS-18 Related Party Disclosures, related party transaction is a transfer of resources or obligations between related parties – provided a price is charged for such transfer.**
   (a) True
   (b) False

5. **According to AS-18 Related Party Disclosures, parties are considered to be related, if and only if at the end of 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.**
   (a) True
   (b) False

Answers to the Multiple Choice Questions

1.	(b)	2.	(d)	3.	(c)	4.	(b)	5.	(b)

Theoretical Questions

6. Who are related parties under AS 18? What are the related party disclosure requirements?

Answer:

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.

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.

7. ABC Limited is in the business of manufacturing textiles. It has certain commercial contracts with its customers and those customer contracts carry various clauses, imposing restriction on ABC Limited for disclosure of certain information. Accordingly, the company doesn't intend to provide related party disclosure under AS - 18 in its ensuing financial statements. Is this correct?

Answer:

As per AS-18 stipulate that related party disclosure requirements under AS-18 **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.

In case, where (1) a statute or (2) a regulator or (3) a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information, which is required to be disclosed as per AS 18, disclosure of such information is **not warranted**. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and AS-18 would not override the obligation to preserve the confidentiality of customers' dealings.

However, this exemption is **not available** in respect of confidentiality provisions in a commercial contract between two enterprises – where confidentiality is not specifically required in terms of (1) a statute or (2) by any regulator or (3) similar competent authority.

Therefore, in the given case AS-18 related party disclosures would have to be made by ABC Limited in its ensuing financial statements.

8. Should the related parties be identified as at the reporting date (i.e. balance sheet date) for the purposes of AS - 18? In disclosing transactions with related parties, are the transactions of the entire reporting period to be disclosed or only those for the period during which related party relationship exists?

Answer:

As per the definition of related parties in AS-18, the existence of a related party relationship should be identified at all points during the year (and not only at the close of the financial year). However, AS 18 requires disclosure of transactions with these parties only during the existence of the related party relationship.

Scenario Based Questions

9. Mr. Raj, a relative of key management personnel, received remuneration of Rs.2,50,000 for his services in the company for the period from 1.4.20X1 to 30.6.20X1. On 1.7.20X1, he left the service of the company.
Should the relative be identified as at the closing date i.e. on 31.3.20X2 for the purposes of AS 18?

Answer:

According to 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 related party for disclosure in the financial statements for the year ended 31.3.20X2.

10. X Ltd. sold goods to its associate company during the 1st quarter ended 30.6.20X1. After that the related party relationship ceased to exist. However goods were supplied as were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.

Answer:

As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.20X1 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist would not be reported.

11. You are required to identify the related parties in the following cases as per AS 18: M Ltd. holds 61 % shares of S Ltd. S Ltd. holds 51 % shares of F Ltd. C Ltd. holds 49% shares of F Ltd. (Give your answer - Reporting Entity wise for M Ltd., S Ltd., C Ltd. and F Ltd.) (PYP Jan 25 4M)

Answer:

As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.20X1 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist would not be reported.

Reporting Entity	Related Party
M Ltd.	S Ltd. (subsidiary) F Ltd.(subsidiary)
S Ltd.	M Ltd. (holding company) F Ltd. (subsidiary)
F Ltd.	M Ltd. (ultimate holding company) S Ltd. (holding company) C Ltd. (investor/ investing party)
C Ltd.	F Ltd. (associate)

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: SP hotels Limited enters into an agreement with Mr. A for running its hotel for a fixed return payable to the later every year. The contract involves the day-to-day management of the hotel, while all financial and operating policy decisions are taken by the Board of Directors of the company. Mr. A does not own any voting power in SP Hotels Limited. Would he be considered as a related party of SP Hotels Limited? Also explain the required related party disclosure requirements under AS 18?

(MTP Sep '23, RTP Nov '22, RTP May '25)

Answer:

Mr. A will not be considered as a related party of SP Hotels Limited in view of AS 18 which states, "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". In the given case, in the absence of share ownership, Mr. A would not be considered to exercise significant influence on SP Hotels Limited, even though there is an agreement giving him the power to manage the company. Further, the fact that Mr. A does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel.

Related Party Disclosures: 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;

- **(a)** Any other elements of the related party transactions necessary for an
- **(b)** understanding of the financial statements;
- **(c)** 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;
- **(d)** Amounts written off or written back in the period in respect of debts due from or to related parties.

Question 2:

(i) Mr. Raj a relative of key management personnel received remuneration of Rs. 2,50,000 for his services in the company for the period from 1.4.2020 to 30.6.2020. On 1.7.2020, he left the service. Should the relative be identified as at the closing date i.e. on 31.3.2021 for the purposes of AS 18? (MTP 5 Marks March 21, Oct'20, Mar'22, Old & New SM) (Same concept different figures PYP 2.5 Marks July'21, PYP 2.5 Marks, Nov '18)

(ii) X Ltd. sold goods to its associate Company during the 1st quarter ending 30.6.2020. After that, the related party relationship ceased to exist. However, goods were supplied as were supplied to any other ordinary customer. Decide whether transactions of the entire year need disclosure as related party transaction. (MTP Mar'22 & Oct '23)

Answer:

(i) According to 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 related party for disclosure in the financial statements for the year ended 31.3.2021.

(ii) As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2020 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.

Question 3: You are required to identify the related parties in the following cases as per AS 18: M Ltd. holds 61 % shares of S Ltd. S Ltd. holds 51 % shares of F Ltd. C Ltd. holds 49% shares of F Ltd. (Give your answer - Reporting Entity wise for M Ltd., S Ltd., C Ltd. and F Ltd.) (MTP Sep '22)

Answer:

(a) Reporting entity- M Ltd.

- S Ltd. (subsidiary) is a related party
- F Ltd.(subsidiary) is a related party

(b) Reporting entity- S Ltd.

- M Ltd. (holding company) is a related party
- F Ltd. (subsidiary) is a related party

(c) Reporting entity- F Ltd.

- M Ltd. (holding company) is a related party
- S Ltd. (holding company) is a related party
- C Ltd. (investor/ investing party) is a related party

(d) Reporting entity- C Ltd.

- F Ltd. (associate) is a related party

Question 4:

(i) On the basis of provisions of AS 18 'Related Party Disclosures': Identify the related parties in the following cases:
X Limited holds 60% shares of Y Limited Y Limited holds 55% shares of W Limited Z Limited holds 35% shares of W Limited

(ii) Himalaya Limited sold goods for ₹ 40 Lakhs to Aravalli Limited during financial year ended on March 31, 2022. The Managing Director of Himalaya Limited owns 80% shares of Aravalli Limited. The sales were made to Aravalli Limited at normal selling prices followed by Himalaya Limited. The chief accountant of Himalaya Limited 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 AS 18. You are required to comment on this. (MTP March '23)

Answer:

(i) X Ltd., Y Ltd. & W Ltd. are related to each other. Z Ltd. & W Ltd. are related to each other by virtue of associate relationship. However, neither X Ltd. nor Y Ltd. is related to Z Ltd. and vice versa since neither control nor significant influence exists between them.

(ii) Himalaya Ltd. and Aravalli Ltd are related parties since key management personnel of Himalaya Ltd. i.e. its managing director holds 80% in Aravalli Ltd. 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 Himalaya Ltd that these sales require no disclosure under related party Transactions, is wrong.

Question 5:

a) In respect of a key supplier who is dependent on the company for its existence and the company enjoys influence over the prices of this supplier (which may not be formally demonstrable), can the supplier and the company be considered as related parties?

b) Define "Key management personnel" in the context of AS 18. (RTP May 22)

Answer:

(a) The supplier and the company cannot be considered to be related parties merely because the latter is able to influence the transaction price between the parties. Paragraph 3 of AS 18 states that "enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise" are considered to be related party relationships. However, the conditions which define the existence of control, as follows, are not satisfied in the given example.

- 'ownership, directly or indirectly, of more than one-half of the voting power of an enterprise, 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, or
- a substantial interest in voting power and the power to direct, by statue or agreement, the financial and/or operating policies of the enterprise". Paragraph 10 of the standard defines significant influence as "participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies". In the given example, although the supplier and the company have entered into a commercial transaction, the terms of which are influenced by the latter because of its better bargaining power in the specific market for such goods, it cannot be concluded that there is participation in the financial and/or operating policy decisions. Therefore, as the conditions specified by the Standard for being classified as a related party are not satisfied in the given example, the company cannot be said to be related to the supplier. This view is supported by paragraph 4 (b) of the Standard which states that "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" would not be deemed to be related parties.

(b) In context of AS 18, "Key management personnel" are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. For example, in the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

Question 6:

Answer the following with respect to AS-18:

(i) ABC Ltd. sold goods of Rs.2,00,000 to its associate company for the 1stquarter ending 30.06.2022. After that the related party relationship ceased to exist. However, goods were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.

(ii) If the majority of directors of Arjun Ltd. constitute the majority of the Board of another Company Bheem Ltd. in their individual capacity as professionals (and not by virtue of their being Directors in Arjun Ltd.). Are both the companies related?

(iii) Asha Ltd. sells all the manufactured furniture of Rs.1,00,00,000 to Sasha Ltd, as per agreement. Sasha Ltd. is the only customer to Asha Ltd. In the financial statements, Asha Ltd. wants to present Sasha company as a related party. Comment on the disclosure requirement.(PYP May '23, MTP Sept 25 S2 7M)

Answer:

i) As per AS 18, parties are considered to be related if any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party. Transactions of ABC Ltd. with its associate company for the first quarter ending 30.06.2022 only are required to be disclosed as related party transactions as the company has the ability to exercise significant influence only till 30.6.2022.

The transactions for the period in which related party relationship did not exist need not be reported.

ii) In the given case, Arjun Ltd. cannot be said to control the composition of board of directors of Bheem Ltd. as the directors have been appointed in their individual capacity as professionals and not by virtue of their being directors in Arjun Ltd.

Hence, it cannot be concluded that the companies are related merely because the majority of the directors of one company became the majority of the directors of the second in their individual capacity as professionals.

iii) In the context of AS 18, a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business cannot be construed as Related Party Relationship merely by virtue of the resulting economic dependence. There is an economic dependence between the companies but no one controls or exercise significant influence on the other.

In the given case, Asha Ltd. need not report Sasha Company as its related party in its financial statements.

Question 7: Will transactions with related parties, for services provided/received free of cost, be required to be disclosed?

A Limited has a corporate communications department, which centralises the public relations function for the whole group of A Limited and its subsidiaries. No charges are, however, levied by A Limited on its subsidiaries and accordingly, these transactions are not given accounting recognition. Would these constitute related party transactions requiring disclosure under AS 18 in the standalone financial statements of A Limited? (RTP Jan 25)

Answer:

These transactions would require disclosure under AS 18 in the standalone financial statements of A Limited. As per paragraph 10 of AS 18, a related party transaction is "a transfer of resources or obligations between related parties, regardless of whether or not a price is charged". In the given situation, there is a transfer of resources from A Limited to its subsidiaries, though no price is charged for the same. Hence, it will constitute as related party transaction and will require disclosure in the financial statements of A Ltd.

Question 8: X Ltd. sold goods to its associate company for the 1st quarter ending 30.6.2024. 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 have to be disclosed as related party transaction. (RTP Sept 25)

Answer:

As per para 23 of AS 18 on 'Related Party Disclosures', transactions of X Ltd., with its associate company for the first quarter ending 30.6.2024 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 to be disclosed as related party transaction

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AS – 19: Leases

Illustrations

Illustration 1

S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:

Lease term = 4 years

Fair value at inception of lease = Rs.20,00,000

Lease rent = Rs.6,25,000 p.a. at the end of year

Guaranteed residual value = Rs.1,25,000

Expected residual value = Rs.3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19 and disclose impact of this on Balance sheet and Profit & loss account at the end of year 1

Solution:

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the lower of the fair value of the leased asset at the inception of the finance lease and the present value of the minimum lease payments from the standpoint of the lessee.

In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Minimum Payment	Lease Rs.	Implicit interest rate (Discount rate @15%)	Present value Rs.
1		6,25,000	0.8696	5,43,500
2		6,25,000	0.7561	4,72,563
3		6,25,000	0.6575	4,10,937
4		7,50,000*	0.5718	4,28,850
Total		26,25,000		18,55,850

Present value of minimum lease payments Rs.18,55,850 is less than fair value at the inception of lease i.e. Rs.20,00,000, therefore, the asset and corresponding lease liability should be recognised at Rs.18,55,850 as per AS 19.

Illustration 2

Prakash Limited leased a machine to Badal Limited on the following terms:

		(Rs.In lakhs)
(i)	Fair value of the machine	28.3
(ii)	Lease term	5 years
(iii)	Lease rental per annum	8.00
(iv)	Guaranteed residual value	1.60
(v)	Expected residual value	3.00
(vi)	Internal rate of return	15%

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively. **(RTP Jan 25)**

Ascertain Unearned Finance Income.

Solution:

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 (GRV)] + Unguaranteed residual value (URV)

= [(Rs.8,00,000 x 5 years) + Rs.1,60,000] + Rs.1,40,000

= Rs.43,00,000 (a)

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

Year	MLP inclusive of URV (Rs.)	Internal rate of return (Discount factor @ 15%)	Present Value (Rs.)
1	8,00,000	0.8696	6,95,680
2	8,00,000	0.7561	6,04,880
3	8,00,000	0.6575	5,26,000
4	8,00,000	0.5718	4,57,440
5	8,00,000	0.4972	3,97,760
	1,60,000 (GRV)	0.4972	79,552
	41,60,000		27,61,312 (i)
	1,40,000 (URV)	0.4972	69,608 (ii)
	43,00,000	(i)+ (ii)	28,30,920 (b)

Unearned Finance Income (a) - (b) = Rs.43,00,000 – Rs.28,30,920= Rs.14,69,080.

Illustration 3

A Ltd. sold machinery having WDV of Rs.40 lakhs to B Ltd. for Rs.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 Rs.50 lakhs is equal to fair value.

(b) Fair value is Rs.60 lakhs.

(c) Fair value is Rs.45 lakhs and sale price is Rs.38 lakhs.

(d) Fair value is Rs.40 lakhs and sale price is Rs.50 lakhs.

(e) Fair value is Rs.46 lakhs and sale price is Rs.50 lakhs

(f) Fair value is Rs.35 lakhs and sale price is Rs.39 lakhs. (MTP Jan 25 S1 4M)

Solution:

Following will be the treatment in the given cases:

(a) When sales price of Rs.50 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of Rs.10 lakhs (i.e. 50 – 40) in its books.

(b) When fair value is Rs.60 lakhs then also profit of Rs.10 lakhs should be immediately recognised by A Ltd.

(c) When fair value of leased machinery is Rs.45 lakhs & sales price is Rs.38 lakhs, then loss of Rs.2 lakhs (40 – 38) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment, otherwise defer and amortise the loss.

(d) When fair value is Rs.40 lakhs & sales price is Rs.50 lakhs then, profit of Rs.10 lakhs is to be deferred and amortised over the lease period.

(e) When fair value is Rs.46 lakhs & sales price is Rs.50 lakhs, profit of Rs.6 lakhs (46 - 40) to be immediately recognised in its books and balance profit of Rs.4 lakhs (50-46) is to be amortised/deferred over lease period.

(f) When fair value is Rs.35 lakhs & sales price is Rs.39 lakhs, then the loss of Rs.5 lakhs (40-35) to be immediately recognised by A Ltd. in its books and profit of Rs.4 lakhs (39-35) should be amortised/deferred over lease period.

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Test Your Knowledge

1. **A Ltd. sold machinery having WDV of Rs.40 lakhs to B Ltd. for Rs.50 lakhs (Fair value Rs.50 lakhs) and same machinery was leased back by B Ltd. to A Ltd. The lease back is in nature of operating lease. The treatment will be**
   (a) A Ltd. should amortise the profit of Rs.10 lakhs over lease term.
   (b) A Ltd. should recognise the profit of Rs.10 lakhs immediately.
   (c) A Ltd. should defer the profit of Rs.10 lakhs.
   (d) B Ltd. should recognise the profit of Rs.10 lakhs immediately.

2. **In case of an operating lease – identify which statement is correct:**
   (a) The lessor continues to show the leased asset in its books of accounts.
   (b) The lessor de-recognises the asset from its Balance Sheet.
   (c) The lessor discontinues to claim depreciation in its books.
   (d) The lessee recognises the asset in its Balance Sheet.

3. **In case of finance lease, if the asset is returned back to the lessor at the end of the lease term - the lessee always claims depreciation based on which of the following:**
   (a) Useful life.
   (b) Lease term.
   (c) Useful life or lease term whichever is less.
   (d) Useful life or lease term whichever is higher.

4. **AS 19 lays down 5 deterministic conditions to classify the lease as a finance lease. To classify the lease as an operating lease – which statement is correct?**
   (a) Any 1 condition fails.
   (b) Majority of the 5 conditions fail.
   (c) All 5 conditions fail.
   (d) Any 2 conditions fails.

5. **The basis of classification of a lease is:**
   (a) Control Test.
   (b) Risk and reward Test.
   (c) Both control test and risk and reward test.
   (d) Only reward Test

Answer to the Multiple Choice Questions

1.	(b)	2.	(a)	3.	(c)	4.	(c)	5.	(b)

Theoretical Questions

6. Explain the types of lease as per AS 19.

Answer:

For the purpose of accounting AS 19, classifies leases into two categories as follows:

1. Finance Lease
2. Operating Lease

Finance Lease:

It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership.

As per para 8 of the standard, in following situations, the lease transactions are called Finance lease:

1. The lessee will get the ownership of leased asset at the end of the lease term.
2. The lessee has an option to buy the leased asset at the end of the lease term at price, which is lower than its expected fair value at the date on which option will be exercised.
3. The lease term covers the major part of the life of asset even if title is not transferred.
4. At the beginning of lease term, present value of minimum lease rental covers the initial fair value.
5. The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

Operating Lease:

It is lease, which does not transfer all the risks and rewards incidental to ownership.

7. Explain the accounting treatment for a sale and leaseback transaction under Operating lease.

Answer:

As per AS 19, where sale and leaseback results in operating lease, then the accounting treatment in different situations is as follows:

Situation 1: Sale price = Fair Value

Profit or loss should be recognized immediately.

Situation 2: Sale Price < Fair Value

Profit should be recognized immediately. The loss should also be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

Situation 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

8. What do you understand by the term "Interest rate implicit on lease"?

Answer:

As per para 3 of AS 19 'Leases' 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.

9. What are the disclosures requirements for operating leases by the lessee as per AS -19?

Answer:

As per AS 19, lessees are required to make following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancelable 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- cancelable subleases at the balance sheet date;

(c) lease payments recognized 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) recognized 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

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Scenario Based Questions

10. Classify the following into either operating or finance lease:

i. Lessee has option to purchase the asset at lower than fair value, at the end of lease term;

ii. Economic life of the asset is 7 years, lease term is 6 years, but asset is not acquired at the end of the lease term;

iii. Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee;

iv. Present value (PV) of Minimum lease payment (MLP) = "X". Fair value of the asset is "Y".

Answer:

(i) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.

(ii) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.

(iii) Since the asset is procured only for the use of lessee, it is a finance lease.

(iv) The lease is a finance lease if X = Y, or where X substantially equals Y.

11. A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost Rs.1,50,000. Economic life of the machine is 5 years and output from the machine are estimated as 40,000 units, 50,000 units, 60,000 units, 80,000 units and 70,000 units consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate. Compute the following:

(i) Annual Lease Rent

(ii) Lease Rent income to be recognized in each operating year and

(iii) Depreciation for 3 years of lease.

Answer:

(i) Annual lease rent

Total lease rent

= 130% of Rs.1,50,000 x Output during lease period / Total output

= 130% of Rs.1,50,000 x (40,000 +50,000+ 60,000)/(40,000 + 50,000 + 60,000 + 80,000 + 70,000)

= 1,95,000 x 1,50,000 units/3,00,000 units = Rs.97,500

Annual lease rent = Rs.97,500 / 3 = Rs.32,500

(ii) Lease rent Income to be recognized in each operating year

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 40 : 50 : 60.

Hence income recognised in years 1, 2 and 3 will be as:

Year 1 Rs.26,000,

Year 2 Rs.32,500 and

Year 3 Rs.39,000.

(iii) Depreciation for three years of lease

Since depreciation in proportion of output is considered appropriate, the depreciable amount Rs.1,50,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 40 : 50 : 60 : 80 :70 .

Depreciation for year 1 is Rs.20,000, year 2 = 25,000 and year 3 = 30,000.

12. Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being Rs.7,00,000. The economic life of machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays Rs.3,00,000. The Lessee has guaranteed a residual value of Rs.22,000 on expiry of the lease to the Lessor. However, Lessor Ltd., estimates that the residual value of the machinery will be only Rs.15,000. The implicit rate of return is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year. (MTP May 24 S1 5M)

Answer:

As per para 11 of AS 19 "Leases", the lessee should recognize the lease as an asset and a liability 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 lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Computation of Value of machinery:

Present value of minimum lease payment = Rs.6,99,054

(See working note below)

Fair value of leased asset = Rs.7,00,000

Therefore, the recognition will be at the lower of the two i.e. 6,99,054

Working Note - Present value of minimum lease payments:

Annual lease rental × PVIF+ Present value of guaranteed residual value

= Rs.3,00,000 × (0.869 + 0.756 + 0.657) + Rs.22,000 × 0.657

= Rs.6,84,600 + Rs.14,454 = 6,99,054

Computation of finance charges:

Year	Finance charge	Payment	Reduction in outstanding liability	Outstanding liability
1st Year beginning	-	-	-	6,99,054
End of 1st year	1,04,858	3,00,000	1,95,142	5,03,912
End of 2nd year	75,587	3,00,000	2,24,413	2,79,499
End of 3rd year	41,925	3,00,000	2,58,075	21,424

13. B&P Ltd. availed a lease from N&L Ltd. The conditions of the lease terms are as under:

(i) Lease period is 3 years, in the beginning of the year 2009, for equipment costing Rs.10,00,000 and has an expected useful life of 5 years.

(ii) The Fair market value is also Rs.10,00,000

(iii) The property reverts back to the lessor on termination of the lease.

(iv) The unguaranteed residual value is estimated at Rs.1,00,000 at the end of the year 2011.

(v) 3 equal annual payments are made at the end of each year.

(vi) Consider IRR = 10%.

The present value off Rs.1 due at the end of 3rd year at 10% rate of interest is Rs.0.7513. The present value of annuity of Rs.1 due at the end of 3rd year at 10% IRR is Rs.2.4868. State whether the lease constitute finance lease and also calculate unearned finance income.

Answer:

Computation of annual lease payment:

Particulars	Rs.
Cost of equipment	10,00,000
Unguaranteed residual value	1,00,000
Present value of unguaranteed residual value	
(Rs.1,00,000 x 0.7513)	75,130
Present value of lease payments	
(Rs.10,00,000 - Rs.75,130)	9,24,870
Present value of annuity for three years is 2.4868	
Annual lease payment [9,24,870/2.4868]	3,71,911.70

Classification of lease:

Parameter 1:

The present value of lease payment i.e., Rs.9,24,870 which equals 92.48% of the fair market value i.e., Rs.10,00,000.

The present value of minimum lease payments substantially covers the fair value of the leased asset

Parameter 2:

The lease term (i.e. 3 years) covers the major part of the life of asset (i.e. 5 years).

Therefore, it constitutes a finance lease.

Computation of Unearned Finance Income:

Particulars	Rs.
Total lease payments (Rs.3,71,911.70 x 3)	11,15,735
Add: Unguaranteed residual value	1,00,000
Gross investment in the lease	1,215,735
Less: Present value of lease payments and residual value i.e.	(10,00,000)
Net Investment (Rs.75,130 + Rs.9,24,870)	
Unearned finance income	**2,15,735**

14. X Ltd. sold machinery having WDV of Rs.300 lakhs to Y Ltd. for Rs.400 lakhs and the same machinery was leased back by Y Ltd. to X Ltd. The lease back arrangement is operating lease.
Give your comments in the following situations:
(i) Sale price of Rs.400 lakhs is equal to fair value.
(ii) Fair value is Rs.450 lakhs.
(iii) Fair value is Rs.350 lakhs and the sale price is Rs.250 lakhs.
(iv) Fair value is Rs.300 lakhs and sale price is Rs.400 lakhs.
(v) Fair value is Rs.250 lakhs and sale price is Rs.290 lakhs.

Answer:

Accounting Treatment:

S. No.	Particulars	Accounting Treatment
(i)	When sale price of Rs.400 lakhs is equal to fair value	X Ltd. should immediately recognize the profit of Rs.100 lakhs (i.e. 400 – 300) in its books.
(ii)	When fair value is Rs.450 lakhs	Profit of Rs.100 lakhs should be immediately recognized by X Ltd.

(iii)	When fair value of leased machinery is Rs.350 lakhs & sales price is Rs.250 lakhs	Then loss of Rs.50 lakhs (300 – 250) to be immediately recognized by X Ltd. in its books provided loss is not compensated by future lease payment.
(iv)	When fair value is Rs.300 lakhs & sales price is Rs.400 lakhs	Then, profit of Rs.100 lakhs is to be deferred and amortized over the lease period.
(v)	When fair value is Rs.250 lakhs & sales price is Rs.290 lakhs	Then the loss of Rs.50 lakhs (300-250) to be immediately recognized by X Ltd. in its books and profit of Rs.40 lakhs (290-250) should be amortized/ deferred over lease period.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1:

(a) Classify the following into either operating or finance lease:

(i) If Present value (PV) of Minimum lease payment (MLP) = "X"; Fair value of the asset is "Y" and X=Y.

(ii) Economic life of the asset is 7 years, lease term is 6.5 years, but asset is not acquired at the end of the lease term;

(iii) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee . (RTP Nov 20)

(b) Viral Ltd. sold machinery having WDV of Rs. 40 lakhs to Saral Ltd. for Rs. 50 lakhs and the same machinery was leased back by Saral Ltd. to Viral Ltd. The lease back is in nature of operating lease. You are required to explain the treatment in the given cases –

(i) Fair value is Rs. 45 lakhs and sale price is Rs. 38 lakhs.

(ii) Fair value is Rs. 40 lakhs and sale price is Rs. 50 lakhs.

(iii) Fair value is Rs. 46 lakhs and sale price is Rs. 50 lakhs (RTP May 22)

Answer:

(a) (i) The lease is a finance lease if X = Y, or if X substantially equals Y.

(ii) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.

(iii) Since the asset is procured only for the use of lessee, it is a finance lease.

(b) As per AS 19, where sale and leaseback results in operating lease, then the accounting treatment in different situations is as follows:

Situation 1: Sale price = Fair Value

Profit or loss should be recognized immediately.

Situation 2: Sale Price < Fair Value

Profit should be recognized immediately. The loss should also be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

Situation 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

Following will be the treatment in the situations given in the question:

(i) When fair value of leased machinery is Rs. 45 lakhs & sales price is Rs. 38 lakhs, then loss of Rs. 2 lakhs (40 – 38) to be immediately recognized by Viral Ltd. in its books provided loss is not compensated by future lease payment.

(ii) When fair value is Rs. 40 lakhs & sales price is Rs. 50 lakhs then, profit of Rs. 10 lakhs is to be deferred and amortized over the lease period When fair value is Rs. 46 lakhs & sales price is Rs. 50 lakhs, profit of Rs. 6 lakhs (46 less 40) to be immediately recognized in its books and balance profit of Rs.4 lakhs (50–46) is to be amortized/deferred over lease period.

Question 2: Jaya Ltd. took a machine on lease from Deluxe Ltd., the fair value being ₹ 11,50,000. Economic life of the machine as well as lease term is 4 years. At the end of each year, lessee pays ₹ 3,50,000 to lessor. Jaya Ltd. has guaranteed a residual value of ₹ 70,000 on expiry of the lease to Deluxe Ltd., however Deluxe Ltd. estimates that residual value will be

only ₹ 25,000. The implicit rate of return is 10% p.a. and present value factors at 10% are : 0.909, 0.826, 0.751 and 0.683 at the end of 1st, 2nd, 3rd and 4th year respectively. Calculate the value of machinery to be considered by Jaya Ltd. and the value of the lease liability as per AS-19. (RTP Nov '23)

Answer:

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee.

In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Minimum Lease Payment ₹	Internal rate of return (Discount rate @10%)	Present value ₹
1	3,50,000	0.909	3,18,150
2	3,50,000	0.826	2,89,100
3	3,50,000	0.751	2,62,850
4	4,20,000*	0.683	2,86,860
Total	14,70,000		11,56,960

Present value of minimum lease payments ₹ 11,56,960 is more than fair value at the inception of lease i.e. ₹ 11,50,000, therefore, the lease liability and machinery should be recognized in the books at ₹ 11,50,000 as per AS 19.

* Minimum Lease Payment of 4th year includes guaranteed residual value amounting i.e. 3,50,000 + 70,000 = 4,20,000.

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Question 3: J Limited availed an equipment on lease from K Limited. The conditions of the lease terms are as under:

(i) Lease starts from 1st April, 2020 for a period of 4 Years and useful life of the equipment is 6 years. Both the cost and fair value of equipment are Rs. 12,50,000.

(ii) The equipment reverts back to the lessor on termination of the lease.

(iii) The unguaranteed residual value is estimated at Rs. 1,20,000 at the end of the financial year 2023-2024.

(iv) The amount will be paid in 4 equal instalments at the end of each year.

(v) Consider IRR = 8%.

(vi) The present value of Rs. 1 at the end of 4th year at 8% of interest is Rs. 0.735.

(vii)The present value of annuity ofRs. 1 due at the end of 4th year at 8% IRR is Rs. 3.312

State whether this lease is operating lease or Finance lease (by applying two deterministic parameters). Also calculate unearned finance Income. (PEP Jan 25 5M)

Answer:

Computation of annual lease payment:

Particulars	Rs.
Cost of equipment	12,50,000.00
Unguaranteed residual value	1,20,000.00
Present value of unguaranteed residual value (Rs. 1,20,000 x 0.735)	88,200.00
Present value of lease payments (Rs. 12,50,000 -Rs. 88,200)	11,61,800.00

Present value of annuity for four years is 3.312	
Annual lease payment [11,61,800/3.312]	3,50,785.02

Classification of lease:

Parameter 1:

The present value of the lease payment i.e. Rs. 11,61,800 which equals 92.94% of the fair market value i.e. Rs. 12,50,000.

The present value of minimum lease payments substantially covers the fair value of the leased asset.

Parameter 2:

The lease term (i.e. 4 years) covers the major part of the life of asset (i.e. 6 years).

Therefore, it constitutes a finance lease.

Computation of Unearned Finance Income:

Particulars	Rs.
Total lease payments (Rs 3,50,785.02 x 4)	14,03,140.08
Add: Unguaranteed residual value	1,20,000.00
Gross investment in the lease	15,23,140.08
Less: Present value of lease payments and residual value i.e.	
Net Investment (Rs. 88,200 + Rs. 11,61,800)	(12,50,000.00)
Unearned finance income	2,73,140.08

Question 4: Sun Limited wishes to obtain a machine costing Rs. 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 3 years. It enters into an agreement with Star Ltd., for a lease rental for Rs. 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Sun Limited is not sure about the treatment of these lease rentals and seeks your advice. (use annuity factor at @ 15% for 3 years as 3.36 (RTP May 25)

Answer:

As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment• amounts to at least substantially all of the fair value of leased asset. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as:

Annuity Factor (Year 1 to Year 3)	3.36
Present Value of minimum lease payments (Rs. 3 lakhs each year)	Rs. 10.08 lakhs (approx.)

Thus, present value of minimum lease payments is Rs.10.08 lakhs and the fair value of the machine is Rs. 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for three years. Therefore, lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense 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 of the user's benefit.

Question 5: On 1st April, 2024, Mansi Ltd. sold a plant for ₹ 8,52,800. The carrying amount of the plant on that date was ₹ 1,80,000. The sale was a part of the package under which Akash Ltd. leased the asset to Mansi Ltd. for eight years term.
The economic life of the asset is estimated as 8 years. The minimum lease rents payable by the lessee has fixed at ₹ 1,60,000 payable annually beginning from 31st March, 2025.

The incremental borrowing interest rate of Mansi Ltd. is estimated at 10% p.a.
Calculate the net effect on the Statement of profit and loss in the books of Mansi Ltd.
(RTP Sept 25)

Answer:

Net effect on the Statement of Profit and Loss in the year of sale in the books of Lessee (Mansi Ltd.)

For calculation of net effect on the statement of profit and loss on sale of equipment, it has to be judged whether lease is an operating lease or finance lease.

The lease term is for 8 years which covers the entire economic life of the equipment. At the inception of the lease, the present value of the minimum lease payments (MLP) is ₹ 8,53,600 [₹ 1,60,000 x 5.335 (Annuity factor of ₹ 1 @10% for 8 years)] and amounts to at least substantially all of the fair value (sale price i.e. ₹ 8,52,800) of the leased equipment. Thus, lease is a finance lease.

As per para 48 of AS 19 "Leases", if a sale and leaseback transaction results in a finance lease, profit of ₹ 6,72,800 (Sale value ₹ 8,52,800 less carrying amount ₹ 1,80,000) will not be recognized as income in the year of sale in the books of lessee i.e. Mansi Ltd. It should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Therefore, assuming that depreciation is charged on straight line basis, Mansi Ltd. will recognize depreciation of ₹ 1,06,600 per annum for 8 years (₹ 8,52,800/8) and amortise profit of ₹ 6,72,800 over the lease term of 8 years, i.e. ₹ 84,100 p.a.

The net effect is a debit of (₹ 1,06,600-84,100) ₹ 22,500 p.a. to the Statement of Profit and Loss, for 8 years as covered under the lease term.

Question 6: Following is the trial balance of ABC Limited as on 31.3.2025.

(Figures in ₹ '000)

Particulars	Debit	Particulars	Credit
Land at cost	800	Equity capital (shares of ₹ 10 each)	500
Calls in arrears	5	10% Debentures	300
Cash in hand	2	General reserve	150
Plant & Machinery at cost	824	Profit & Loss A/c (F.Y. 2023-24)	75
Trade receivables	120	Securities premium	40
Inventories (31-3-25)	96	Sales	1200
Cash at Bank	28	Trade payables	30
Adjusted Purchases	400	Provision for depreciation	150
Factory expenses	80	Suspense Account	10
Administrative expenses	45		
Selling expenses	25		
Debenture Interest	30		
	2455		2455

Additional Information:

(i) The authorized share capital of the company is 80,000 shares of ₹ 10 each.

(ii) The company revalued the land at ₹ 9,60,000.

(iii) Equity capital includes shares of ₹ 50,000 issued for consideration other than cash.

(iv) Suspense account of ₹ 10,000 represents cash received from the sale of some of the machinery on 1.4.2024. The cost of the machinery was ₹ 24,000 and the accumulated depreciation thereon being ₹ 20,000.

(v) Depreciation is to be provided on plant and machinery at 10% on cost.

(vi) Balance at bank includes ₹ 5,000 with Abhay Bank Ltd., which is not a Scheduled Bank. You are required to prepare ABC Limited's Balance Sheet as on 31.3.2025 and Statement of Profit and Loss with notes to accounts for the year ended 31.3.2025 as per Schedule III. Ignore previous year's figures & taxation. (RTP Sept 25)

Answer:

ABC Limited

Balance Sheet as at 31st March 2025

Particulars	Note No.	(₹ in '000)
A. Equity and Liabilities		
1. Shareholder's funds		
(a) Share Capital	1	495.00
(b) Reserves and Surplus	2	971.00
2. Non-Current Liabilities		
(a) Long Term Borrowings	3	300.00
3. Current Liabilities		
(a) Trade Payables		30.00
		1,796.00
Total		
B. Assets		
1. Non-Current Assets		
(a) Property, Plant and Equipment	4	1,550.00
2. Current Assets		
(a) Inventories		96.00
(b) Trade Receivables		120.00
(c) Cash and Cash equivalents	5	30.00
Total		1,796.00

ABC Limited

Statement of Profit and Loss for the year ended 31st March 2025

Particulars	Note No.	(₹ in '000)
I. Revenue from Operations		1200.00
II. Other Income	6	6.00
III. Total Revenue		1,206.00
IV. Expenses:		
Purchases		400.00
Finance Costs	7	30.00
Depreciation (10% of 800)		80.00
Other expenses	8	150.00
Total Expenses		660.00
V. Profit / (Loss) for the period (III – IV)		546.00

Notes to Accounts

Particulars	(₹ in '000)
1. Share Capital	
Equity Share Capital	
Authorised	
80,000 Shares of ₹ 10/- each	800

Issued, Subscribed and Called-up		
50,000 Shares of ₹ 10/- each	500	
(Out of the above 5,000 shares have been issued for consideration other than cash)		
Less: Calls in arrears	(5)	495
2. Reserves and Surplus		
Securities Premium Account		40
General Reserve		150
Profit & Loss Balance		
Opening Balance	75	
Add: Profit for the period	546	621
Revaluation Reserve ₹ (960 – 800)		160
		971
3. Long-Term Borrowings		
10% Debentures		300
4. PPE		
Land		
Opening Balance	800	
Add: Revaluation adjustment	160	
Closing Balance		960
Plant and Machinery		
Opening Balance	824	
Less: Disposed off	(24)	
	800	
Less: Depreciation ₹ (150 – 20 + 80)	*(210)*	
Closing Balance		590
Total		1,550
5. Cash and Cash Equivalents		
Cash at Bank		
With scheduled banks	23	
With others (Abhay Bank Limited)	5	
Cash in hand	2	30
6. Other Income		
Profit on sale of machinery		
Sale value of machinery		10
Less: Book value of machinery (24 – 20)	(4)	6
7. Finance Costs		
Debenture Interest		30
8. Other Expenses:		
Factory expenses		80
Selling expenses		25
Administrative expenses	45	150

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AS – 20: Earnings per Share

Illustrations

Illustration 1

Date	Particulars			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.

Illustration 2

Date	Particulars	No. of Shares	Face Value	Paid up Value
1st January	Balance at beginning of year	1,800	Rs.10	Rs.10
31st October	Issue of Shares	600	Rs.10	Rs.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.

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.

Illustration 3

Net profit for the year 20X1	**Rs.18,00,000**
Net profit for the year 20X2	**Rs.60,00,000**
No. of equity shares outstanding until 30th September 20X2	**20,00,000**

Bonus issue 1st October 20X2 was 2 equity shares for each equity share outstanding at 30th September, 20X2

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 20X2 $\frac{\text{Rs.60,00,000}}{\text{20,00,000 + 40,00,000}}$ = Rs.1.00

Adjusted earnings per share for the year 20X1 $\frac{\text{Rs.18,00,000}}{\text{20,00,000 + 40,00,000}}$ = Rs.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 20X1, the earliest period reported.

The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. 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.

[Thus, it may be noted that if a company makes a right issue at fair value itself, then there will be no bonus element in the right issue].

The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

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

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 20X1	**Rs.11,00,000**
Net profit for the year 20X2	**Rs.15,00,000**
No. of shares outstanding prior to rights issue	**5,00,000 shares**
Rights issue price	**Rs.15.00**
Last date to exercise rights	**1st March 20X2**

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 20X2 was Rs.21.00. Compute Basic Earnings Per Share. **(MTP Jan 25 S1 4M)**

Solution:

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

$$\frac{\text{(Rs.21.00 x 5,00,000 shares) + (Rs.15.00 x 1,00,000 shares)}}{\text{5,00,000 shares + 1,00,000 shares}}$$

Theoretical ex-rights fair value per share = Rs.20.00

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{Rs.(21.00)}}{\text{Rs.(20.00)}} = 1.05$$

Computation of earnings per share:

EPS for the year 20X1 as originally reported: Rs.11,00,000/5,00,000 shares = 2.20

EPS for the year 20X1 restated for rights issue: Rs.11,00,000/ (5,00,000 shares x 1.05)

= Rs.2.10

EPS for the year 20X2 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 = Rs.2.55

Illustration 5

Net profit for the current year	**Rs.1,00,00,000**
No. of equity shares outstanding	**50,00,000**
Basic earnings per share	**Rs.2.00**
No. of 12% convertible debentures of Rs.100 each	**1,00,000**
Each debenture is convertible into 10 equity shares	
Interest expense for the current year	**Rs.12,00,000**
Tax relating to interest expense (30%)	**Rs.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) = Rs.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) = Rs.1.81

Illustration 6

Net profit for the year 20X1	**Rs.12,00,000**
Weighted average number of equity shares outstanding during the year 20X1	**5,00,000 shares**
Average fair value of one equity share during the year 20X1	**Rs.20.00**
Weighted average number of shares under option during the year 20X1	**1,00,000 shares**
Exercise price for shares under option during the year 20X1	**Rs.15.00**

Compute Basic and Diluted Earnings Per Share.

Solution:

Computation of earnings per share

	Earnings Rs.	Shares	Earnings/Share Rs.
Net profit for the year 20X1	12,00,000		
Weighted average no. of shares during year 20X1	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

X Limited, during the year ended March 31, 20X1, has income from continuing ordinary operations of Rs.2,40,000, a loss from discontinuing operations of Rs.3,60,000 and accordingly a net loss of Rs.1,20,000. The Company has 1,000 equity shares and 200 potential equity shares outstanding as at March 31, 20X1.

You are required to compute Basic and Diluted EPS?

Solution:

As per AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations". As income from continuing ordinary operations, Rs.2,40,000 would be considered and not Rs.(1,20,000), for ascertaining whether 200 potential equity shares are dilutive or anti-dilutive. Accordingly, 200 potential equity shares would be dilutive potential equity shares since their inclusion would decrease the net profit per share from continuing ordinary operations from Rs.240 to Rs.200. Thus, the basic E.P.S would be Rs.(120) and diluted E.P.S. would be Rs.(100).

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Test Your Knowledge

1. **AB Company Ltd. had 1,00,000 shares of common stock outstanding on January 1. Additional 50,000 shares were issued on July 1, and 25,000 shares were reacquired on September 1. The weighted average number of shares outstanding during the year on Dec. 31 is**
   (a) 1,40,000 shares
   (b) 1,25,000 shares
   (c) 1,16,667 shares
   (d) 1,20,000 shares

2. **As per AS 20, potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would**
   (a) Decrease net profit per share from continuing ordinary operations.
   (b) Increase net profit per share from continuing ordinary operations.
   (c) Make no change in net profit per share from continuing ordinary operations.
   (d) Decrease net loss per share from continuing ordinary operations.

3. **As per AS 20, equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements are**
   (a) Dilutive potential equity shares
   (b) Contingently issuable shares
   (c) Contractual issued shares
   (d) Potential equity shares

4. **In case potential equity shares have been cancelled during the year, they should be:**
   (a) Ignored for computation of Diluted EPS.
   (b) Considered from the beginning of the year till the date they are cancelled.
   (c) The company needs to make an accounting policy and can follow the treatment in (a) or (b) as it decides.
   (d) Considered for computation of diluted EPS only if the impact of such potential equity shares would be material.

5. **Partly paid up equity shares are:**
   (a) Always considered as a part of Basic EPS.
   (b) Always considered as a part of Diluted EPS.
   (c) Depending upon the entitlement of dividend to the shareholder, it will be considered as a part of Basic or Diluted EPS as the case may be.
   (d) Considered as part of Basic/ Diluted EPS depending on the accounting policy of the company.

Answers to the Multiple Choice Questions

1.	(c)	2.	(a)	3.	(b)	4.	(b)	5.	(c)

Theoretical Questions

6. In the following list of shares issued, for the purpose of calculation of weighted average number of shares, from which date weight is to be considered:

i. Equity Shares issued in exchange of cash,

ii. Equity Shares issued as a result of conversion of a debt instrument,

iii. Equity Shares issued in exchange for the settlement of a liability of the enterprise,

iv. Equity Shares issued for rendering of services to the enterprise,

v. Equity Shares issued in lieu of interest and/or principal of an other financial instrument,

vi. Equity Shares issued as consideration for the acquisition of an asset other than in cash.

Also define Potential Equity Share.

Answer:

The following dates should be considered for consideration of weights for the purpose of calculation of weighted average number of shares in the given cases:

i. Date of Cash receivable

ii. Date of conversion

iii. Date on which settlement becomes effective

iv. When the services are rendered

v. Date when interest ceases to accrue

vi. Date on which the acquisition is recognised.

A Potential Equity Share is a financial instrument or other contract that entitles or may entitle its holder to equity shares

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7. Stock options have been granted by AB Limited to its employees and they vest equally over 5 years, i.e., 20 per cent at the end of each year from the date of grant. The options will vest only if the employee is still employed with the company at the end of the year. If the employee leaves the company during the vesting period, the options that have vested can be exercised, while the others would lapse. Currently, AB Limited includes only the vested options for calculating Diluted EPS.

Should only completely vested options be included for computation of Diluted EPS? Is this in accordance with the provisions of AS 20? Explain.

Answer:

As per AS 20 "A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares".

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 are examples of potential equity shares. Further, for the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

The current method of calculating Diluted EPS adopted by AB limited is not in accordance with AS 20. The calculation of Diluted EPS should include all potential equity shares, i.e., all the stock options granted at the balance sheet date, which are dilutive in nature, irrespective of the vesting pattern.

The options that have lapsed during the year should be included for the portion of the period the same were outstanding, pursuant to the requirement of the standard.

8. Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?

Answer:

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

However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

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Scenario Based Questions

9. NAT, a listed entity, as on 1st April, 20X1 had the following capital structure:

Particulars	Rs.
10,00,000 Equity Shares having face value of Rs.1 each	10,00,000
10,00,000 8% Preference Shares having face value of Rs.10 each	1,00,00,000

During the year 20X1-20X2, the company had profit after tax of Rs. 90,00,000.

On 1st January, 20X2, NAT made a bonus issue of one equity share for every 2 equity shares outstanding as at 31st December, 20X1.

On 1st January, 20X2, NAT issued 2,00,000 equity shares of Rs. 1 each at their full market price of Rs. 7.60 per share.

NAT's shares were trading at Rs. 8.05 per share on 31st March, 20X2.

Further it has been provided that the basic earnings per share for the year ended 31st March, 20X1 was previously reported at Rs. 62.30.

You are required to:

(i) Calculate the basic earnings per share to be reported in the financial statements of NAT for the year ended 31st March, 20X2 including the comparative figure, in accordance with AS-20 Earnings Per Share.

(ii) Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?

Answer:

(i) Computation of Basic Earnings per share for the year ended 31st March, 20X2:

(including the comparative figure)

Working Note – I:

Earnings for the year ended 31st March, 20X1:

= EPS x Number of shares outstanding during 20X0-20X1

= Rs.62.30 x 10,00,000 equity shares

= Rs.6,23,00,000

Adjusted/Restated Earnings per share for the year ended 31st March 20X1:

(after taking into consideration bonus issue)

Adjusted/Restated Basic EPS:

= Earnings for the year 20X0-20X1 / (Total outstanding shares +Bonus issue)

= Rs.6,23,00,000 / (10,00,000+ 5,00,000)

= Rs.6,23,00,000 / 15,00,000

= Rs.41.53 per share

Computation of Basic EPS for the year 20X1-20X2:

Basic EPS = (Total Earnings – Preference Shares Dividend) / (Total shares outstanding at the beginning + Bonus issue + weighted average of the shares issued in January, 20X2)

= (Rs.90,00,000 – Rs.(1,00,00,000 x 8%)) / (10,00,000 + 5,00,000 + (2,00,000 x 3/12))

= Rs.82,00,000 / 15,50,000 shares

= Rs.5.29 per share

(ii) In case of a bonus issue, 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.

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 20X1, the earliest period reported.

However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

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

(Accounting year 1.1.20X1– 31.12.20X1)	
Net Profit	**: Year 20X1: Rs.20,00,000**
	: Year 20X2: Rs.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 – Rs.20
	Last date of exercise rights– 31.3.20X2.
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.20X2	**: Rs.25**

Answer:

Computation of Basic Earnings Per Share

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

	Year 20X1	**Year 20X2**
	Rs.	**Rs.**
EPS for the year 20X1 as originally reported		
Net Profit of the year attributable to equity shareholders / Weighted average number of equity shares outstanding during the year		
= (Rs.20,00,000 / 10,00,000 shares)	2.00	
EPS for the year 20X1 restated for rights issue		
= [Rs.20,00,000 / (10,00,000 shares x 1.04*)]	1.91	
	(approx.)	
EPS for the year 20X2 including effects of rights issue		
Rs.30,00,0 00 / (10,00,000 shares x 1.04 x 3/12) (12,50,000 shares x 9/12)		
Rs.30,00,000 / 11,97,500shares		2.51 (approx.)

Working Notes:

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

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

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

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

2. **Computation of adjustment factor**

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

$$\frac{\text{Rs.25}}{\text{4,57,500 Shares (as per working share)}} = 1.04 \text{ (approx.)}$$

11. On 1st April, 20X1 a company had 6,00,000 equity shares of Rs.10 each (Rs.5 paid up by all shareholders). On 1st September, 20X1 the remaining Rs.5 was called up and paid by all shareholders except one shareholder having 60,000 equity shares. The net profit for the year ended 31st March, 20X2 was Rs.21,96,000 after considering dividend on preference shares of Rs.3,40,000.
You are required to compute Basic EPS for the year ended 31st March, 20X2 as per Accounting Standard 20 "Earnings Per Share". (MTP Mar'22, March '23 & Oct '23)

Answer:

Basic Earnings per share (EPS) =

$$\frac{\text{Net Profit attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$$

$$\frac{\text{21,96,000}}{\text{4,57,500 Shares (as per working share)}} = \text{Rs.4.80 per share}$$

Working Note:

Calculation of weighted average number of equity shares

As per AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period.

Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated as follows:

Date	No. of equity shares	Amount paid per share	Weighted average no. of equity shares
	Rs.	Rs.	Rs.
1.4.20X1	6,00,000	5	6,00,000 x 5/10 x 5/12 = 1,25,000
1.9.20X1	5,40,000 1	0	5,40,000 x 7/12 = 3,15,000
1.9.20X1	60,000	5	60,000 x 5/10 x 7/12 = 17,500

Total weighted average equity shares 4,57,500

12. No. of equity shares outstanding = 30,00,000
Basic earnings per share Rs.5.00
No. of 12% convertible debentures of Rs.100 each; 50,000
Each debenture is convertible into 10 equity shares
Tax Rate 30%
Compute Diluted Earnings per Share.
Working notes should form part of the answer.

Answer:

Earnings for the year:

= No. of Shares x Basic EPS

= 30,00,000 shares x Rs.5 per share = Rs.1,50,00,000

Computation of Adjusted Net Profit:

= Earnings for the year + Interest on debentures net of tax

= 1,50,00,000 + (6,00,000 - 1,80,000) = Rs.1,54,20,000

Computation of Adjusted Denominator:

No. of equity shares resulting from conversion of debentures:

= 50,000 x 10 shares = 5,00,000 shares

No. of equity shares for diluted EPS = 30,00,000 + 5,00,000

= 35,00,000 shares

Computation of Diluted EPS:

= Rs.1,54,20,000/35,00,000 shares = Rs.4.4 per share.

13. Following information is supplied by K Ltd.:

Number of shares outstanding prior to right issue - 2,50,000 shares.

Right issue - two new share for each 5 outstanding shares (i.e. 1,00,000 new shares)

Right issue price - Rs.98

Last date of exercising rights - 30-06-20X2.

Fair value of one equity share immediately prior to exercise of right on 30-06-20X2 is Rs.102.

Net Profit to equity shareholders:

20X1-20X2 - Rs.50,00,000

20X2-20X3 -Rs.75,00,000

You are required to calculate the basic earnings per share as per AS-20 Earnings per Share.

Answer:

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

$$\frac{102 \times 2,50,000 \text{ shares} + Rs.98 \times 1,00,000 \text{ shares}}{3,50,000 \text{ shares}}$$

Theoretical ex-rights fair value per share = Rs.100.86

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = 102/100.86 = 1.01$$

Computation of earnings per share:

EPS for the year 20X1-X2 as originally reported: Rs.50,00,000/2,50,000 shares = Rs.20

EPS for the year 20X1-X2 restated for rights issue: =Rs.50,00,000/ (2,50,000 shares x 1.01)

= Rs.19.80

EPS for the year 20X2-X3 including effects of rights issue:

EPS = 75,00,000/3,25,625* = Rs.23.03

* [(2,50,000 x 1.01 x 3/12) + (3,50,000 x 9/12)] =63,125 + 2,62,500 = 3,25,625 shares

Note: Financial year (ended 31st March) is considered as accounting year while giving the above answer.

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: From the following information, you are required to compute Basic and Diluted Earnings Per Share (EPS) of M/s. XYZ Limited for the year ended 31st March, 2019:

Net Profit for the year after tax: Rs. 75,00,000

Number of Equity Shares of Rs.10 each outstanding: Rs. 10,00,000

1,00,000, 8% Convertible Debentures of Rs. 100 each were issued by the Company at the beginning of the year. 1,10,000 Equity Shares were supposed to be issued on conversion. Consider rate of IncomeTax as 30% (RTP Nov'22)

Answer:

Computation of basic earnings per share

Net profit for the current year / Weighted average number of equity shares outstanding during the year Rs. 75,00,000 / 10,00,000 = Rs. 7.50 per share

Computation of diluted earnings per share $\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$

	Rs.
Net profit for the current year	75,00,000
Add: Interest expense for the current year	8,00,000
Less: Tax relating to interest expense (30% of Rs.8,00,000)	(2,40,000)
Adjusted net profit for the current year	80,60,000

Number of equity shares resulting from conversion of debentures

= 1,10,000 Equity shares (given in the Question)

Weighted average number of equity shares used to compute diluted earnings per share

= 11,10,000 shares (10,00,000 + 1,10,000)

Diluted earnings per share

= Rs. 80,60,000/ 11,10,000

= Rs. 7.26 per share

Note: Conversion of convertible debentures into Equity Share will be dilutive potential equity shares. Hence, to compute the adjusted profit the interest paid on such debentures will be added back as the same would not be payable in case these are converted into equity shares.

Question 2: From the following information you are required to compute the basic and adjusted Earnings per share:

Net profit for 2015-16	**11 lakh**
Net profit for 2016-17	**15 lakh**
No. of shares issued before rights issue	**5 lakhs**
Right issue	**One for every 5 held**
Right issue price	**15 per share**
Last date of exercising right option	**1-06-2016**
Fair value of shares before right issue	**21 per share**

(MTP Sep'22
RTP May'23)

Answer:

Computation of theoretical ex-rights fair value per Share

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

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

Theoretical ex-rights fair value per share = Rs. 20.00

Computation of earnings per share

(a) Computation of adjustment factor

(b) $\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{(21.00)}{(20.00)} = 1.05$

(b)

Computation of earnings per share	**Year 2015-16**	**Year 2016-17**
EPS for the year 2015-16 as originally reported: (Rs. 11,00,000/5,00,000 shares)	Rs.2.20	
EPS for the year 2015-16 restated for rights issue: [Rs. 11,00,000/ (5,00,000 shares x 1.05)]	Rs.2.10	
EPS for the year 2016-17 including effects of rights issue $\frac{15{,}00{,}000}{\left(5{,}00{,}000 \times \frac{2}{12}\right) + \left(6{,}00{,}000 \times \frac{10}{12}\right)}$		Rs. 2.55

Question 3:

a) Stock options have been granted by AB Limited to its employees and they vest equally over 5 years, i.e., 20 per cent at the end of each year from the date of grant. The options will vest only if the employee is still employed with the company at the end of the year. If the employee leaves the company during the vesting period, the options that have vested can be exercised, while the others would lapse. Currently, AB Limited includes only the vested options for calculating Diluted EPS. Should only completely vested options be included for computation of Diluted EPS? Is this in accordance with the provisions of AS 20? Explain.

b) X Limited, as at March 31, 2021, has income from continuing ordinary operations of Rs. 2,40,000, a loss from discontinuing operations of Rs. 3,60,000 and accordingly a net loss of Rs. 1,20,000. The Company has 1,000 equity shares and 200 potential equity shares outstanding as at March 31, 2021. You are required to compute Basic and Diluted EPS?

(RTP May 22)

Answer:

a) The current method of calculating Diluted EPS adopted by AB limited is not in accordance with AS 20. The calculation of Diluted EPS should include all potential equity shares, i.e., all the stock options granted at the balance sheet date, which are dilutive in nature, irrespective of the vesting pattern. The options that have lapsed during the year should be included for the portion of the period the same were outstanding, pursuant to the requirement of the standard.

AS 20 states that "A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares"; 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 are examples of potential equity shares. Further, for the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity

shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

b) As per AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations"; As income from continuing ordinary operations, Rs. 2,40,000 would be considered and not Rs. (1,20,000), for ascertaining whether 200 potential equity shares are dilutive or anti-dilutive. Accordingly, 200 potential equity shares would be dilutive potential equity shares since their inclusion would decrease the net profit per share from continuing ordinary operations from Rs. 240 to Rs. 200. Thus the basic E.P.S would be Rs. (120) and diluted E.P.S. would be Rs. (100).

Question 4: NAT, a listed entity, as on 1st April,2021 had the following capital structure:

	₹
10,00,000 Equity Shares having face value of ₹ 1 each	10,00,000
10,00,000 8% Preference Shares having face value of ₹ 10 each	1,00,00,000

During the year 2021-2022, the company had profit after tax of ₹ 90,00,000

On 1st January,2022, NAT made a bonus issue of one equity share for every 2 equity shares outstanding as at 31st December,2021.

On 1st January,2022, NAT issued 2,00,000 equity shares of ₹ 1 each at their full market price of ₹ 7.60 per share.

NAT's shares were trading at ₹ 8.05 per share on 31st March,2022.

Further it has been provided that the basic earnings per share for the year ended 31st March,2021 was previously reported at ₹ 62.30.

You are required to:

Calculate the basic earnings per share to be reported in the financial statements of NAT for the year ended 31st March,2022 including the comparative figure, in accordance with AS-20 Earnings Per Share.

Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share? (PYP May'22)

Answer:

I. Calculation of Basic Earnings per share for the year ended 31stMarch, 2022 including the comparative figure:

Earnings for the year ended 31st March, 2021

= EPS x Number of shares outstanding during 2020 – 2021

= ₹ 62;30 x 10,00,000 equity shares

= ₹ 6,23,00,000

(a) Adjusted Earnings per share after taking into consideration bonus issue

Adjusted Basic EPS = Earnings for the year 2020–2021 / Total outstanding shares +Bonus issue

= ₹ 6,23,00,000 / (10,00,000+ 5,00,000)

= ₹ 6,23,00,000 / 15,00,000

= ₹ 41;53 per share

(b) Basic EPS for the year 2021–2022

Basic EPS = Total Earnings – Preference Shares Dividend) / (Total shares outstanding at the beginning + Bonus issue + weighted average of the shares issued in January, 2022)

= (₹ 90,00,000 – ₹ (1,00,00,000 x 8%) / (10,00,000 + 5,00,000 + (2,00,000 x 3/12))

= ₹ 82,00,000 / 15,50,000 shares = ₹ 5;29 per share

II. In case of a bonus issue, 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. 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 2021, the earliest period reported.

However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

Question 5: The following information is provided to you:
Net profit for the year 2022: ₹ 72,00,000 Weighted average number of equity shares outstanding during the year 2022: 30,00,000 shares
Average Fair value of one equity share during the year 2022: ₹ 25.00 Weighted average number of shares under option during the year 2022: 6,00,000 shares Exercise price for shares under option during the year 2022: ₹ 20.00
You are required to compute Basic and Diluted Earnings Per Share as per AS 20. (PYP Nov'22)

Answer :

Computation of Basic earnings per share

	Earnings ₹	Shares	Earnings/ Share ₹
Net profit for the year 2022	72,00,000		
Weighted average no. of shares during year 2022 Basic earnings per share (72,00,000/30,00,000)		30,00,000	2.40

Computation of Diluted earnings per share

	Earnings	Shares	Earnings/Share
	₹		₹
Net profit for the year 2022	72,00,000		
Weighted average no. of shares during		30,00,000	
year 2022			
Number of shares under option		6,00,000	
Number of shares that would have been			
issued at fair value			
(6,00,000 x 20.00)/25.00		(4,80,000)	
Diluted earnings per share	72,00,000	31,20,000	2.31
			(rounded-off)

Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (1,20,000) deemed for the purpose of the computation to have been issued for no consideration.

To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of options.

Question 6: XYZ Limited has provided you the following information as on 31st March
Question 7: 2024:

Particulars	Rs.

Net profit (After Tax)	Rs. 31,20,000
No. of shares outstanding as on 31-3-2024 of Rs. 10 each	8,00,000
Average fair value of one equity share during the year 2023-24	Rs. 25
Weighted average on. Of shares under option during the year 2023-24	80,000
Exercise price for shares under option during the year 2023-24	Rs. 20
12% Debentures of Rs. 100 each	Rs. 30,00,000
(Each debenture is convertible into 4 equity shares)	
Tax rate	30%

The company issued one equity share as bonus for every 5 equity shares outstanding as on 1st October 2023. It further issued 2,00,000 equity shares of Rs. 10 each as on 1stJanuary 2024. The Financial Year of the company ends on 31st March each year.

You are required to calculate Basic and Diluted earnings per share as on 31st March 2024 (round off your answer to 2 decimal places). (PEP Jan 25 5M)

Answer:

Computation of Basic Earnings per Share

	Earnings Rs.	No. of Shares	EPS Rs.
Earnings per share for the year 2023- 2024	31,20,000	6,50,000 (W.N 2)	4.80
Computation of Dilutive Earnings per Share			
Net profit for the year		31,20,000	
Weighted average number of shares (W.N. 2) outstanding during year on 31.3.2024 (i)		6,50,000	
Number of shares under option		80,000	
Number of shares that would have been issued at fair value: (80,000 x 20.00)/25.00		(64,000)	
No. of incremental shares issued for no consideration (ii)		16,000	
Diluted earnings per share after options	31,20,000	6,66,000 (i + ii)	4.68
12% Convertible Debentures (W.N. 3)	2,52,000	1,20,000	-
Diluted earnings	33,72,000	7,86,000	4.29

Working notes:

1. **Computation of shares issued on bonus**

No. of shares outstanding as on 31st March 2024	8,00,000
Less: Shares issued on 1st Jan 2024	(2,00,000)
Outstanding shares as on 31st December 2023	6,00,000
Bonus shares (6,00,000 x 1/(1+5))	1,00,000
Outstanding shares before bonus issue as on 1st April 2023 (6,00,000x5/6)	5,00,000

2. **Weighted Average number of Equity shares**

	Shares	Months	Weighted average
Opening balance as on 1.4.2023	5,00,000(W.N.1)	12/12	5,00,000
Bonus	1,00,000	12/12	1,00,000
Further issue of shares on 1.1.2024	2,00,000	3/12	50,000
			6,50,000

3. **12% Convertible Debentures**

Increase in net profit {Rs. 30,00,000 x 0.12 x (1 -0.30)}	Rs. 2,52,000
No. of incremental shares {30,000 x 4}	1,20,000

Question 8: On 1 April 2023, ABC Limited has given the following information:

	Rs.
50,000 equity shares of Rs. 100 each (Rs. 80 paid up by all shareholders)	40,00,000
2,00,000 8% Preference shares of Rs. 10 each	20,00,000
10,000, 12% Debentures of Rs. 100 each (Each debenture is convertible into 3 equity shares of Rs. 100 each)	10,00,000

On 1" July 2023, the remaining Rs. 20 was called up and paid by all the shareholders except one shareholder holding 10,000 equity shares. During the year 2023-24 the company had a profit after tax of Rs. 3,44,000.

Tax rate is 30%.

You are required to compute Basic and Diluted EPS. (PEP May 24 4M)

Answer:

Basic Earnings per share (EPS) =

$$\frac{\text{Net profit attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$$

$$\frac{1,84,000}{46,000 \text{ Shares (as per working note)}} = \text{Rs. 4 per share}$$

Diluted earnings per share

Net profit for the current year	Rs. 3,44,000
No. of equity shares outstanding	50,000
Basic earnings per share	Rs. 4
No. of 12% convertible debentures of Rs. 100 each Each debenture is convertible into 3 equity shares	10,000
Interest expense for the current year	Rs. 1,20,000
Tax relating to interest expense (30%)	Rs. 36,000
Adjusted net profit for the current year	Rs. (1,84,000 + 1,20,000 - 36,000) = Rs. 2,68,000
No. of equity shares resulting from conversion of debentures	30,000
No. of equity shares used to compute diluted earnings per share	46,000 + 30,000 = 76,000
Diluted earnings per share	2,68,000 / 76,000 = Rs. 3.53

Working Note:

1. **Net profit attributable to equity share holders = Net profit less preference dividends**
   Total earnings – preference shares dividend
   Rs. 3,44,000 – Rs. (8% x 20,00,000)
   Rs. 3,44,000 - Rs. 1,60,000
   = Rs. 1,84,000
2. **Calculation of weighted average number of equity shares**
   As per AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated

as follows:

Date	No. of equity shares	Amount paid per share	Weighted average no. of equity shares
	Rs.	Rs.	Rs.
01.04.2023	50,000	80	50,000x 80/100x 3/12 = 10,000
01.07.2023	40,000	100	40,000 x 9/12 = 30,000
01.07.2023	10,000	80	10,000x 80/100x 9/12 = 6,000
Total weighted average equity shares			**46,000**

Question 9: XYZ Limited has a wholly owned subsidiary BC Limited. The Group prepares consolidated Financial Statements for the year ended 31st March, 2024. XYZ Limited (in its separate financial statements) has incurred a loss of Rs. 2 crore during the year, while the consolidated profit for the group during the year is Rs. 40 lakh.
XYZ Limited has 5,00,000 shares outstanding as at 31st March, 2024. Further, it has granted options to issue equity shares as at that date. In respect of such options, 1,00,000 shares are considered to be the shares issued for no consideration. There are no changes in income or expenses that are expected from the issue of equity shares on exercise of these options.
Calculate Basic and Diluted EPS for XYZ Limited for separate financial statements and for the Group (RTP Jan 25)

Answer:

Computation of earnings per share

Particulars	Consolidated financial statements	Standalone financial statements of XYZ Limited
Basic earnings/(loss) per share	Rs. 8 [40,00,000/5,00,000]	(Rs. 40) [2,00,00,000/ 5,00,000]
Diluted earnings/ (loss) per share	Rs. 6.66 [40,00,000/ 6,00,000]	(Rs. 40) [2,00,00,000/ 5,00,000]

As per paragraph 39 of AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

In the above case, if the exercise of options was considered for separate financial statements of XYZ Limited, the diluted loss per share would have reduced to Rs. 33.33 [2,00,00,000/6,00,000]. As this is antidilutive, the options would not be treated as potentially dilutive equity shares. Accordingly, in the separate financial statements of XYZ Limited, the Diluted EPS would be same as Basic EPS.

AS – 22: Accounting for Taxes on Income

Illustrations

Illustration 1

Rama Ltd., has provided the following information:

	Rs.
Depreciation as per accounting records	= 2,00,000
Depreciation as per income tax records	= 5,00,000
Unamortised preliminary expenses as per tax record	= 30,000

There is adequate evidence of future profit sufficiency. How much net deferred tax asset/liability should be recognised as transition adjustment? Tax rate 50%.

Solution:

Table showing calculation of deferred tax asset / liability

Particulars	Amount	Timing differences	Deferred tax	Amount @ 50%
	Rs.			Rs.
Excess depreciation as per tax records (Rs. 5,00,000 – Rs. 2,00,000)	3,00,000	Timing	Deferred tax liability	1,50,000
Unamortised preliminary expenses as per tax records	30,000	Timing	Deferred tax asset	(15,000)
Net deferred tax liability				1,35,000

Illustration 2

From the following details of A Ltd. for the year ended 31-03-20X1, calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Particulars	Rs.
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 x 20% = Rs. 1,20,000

Tax as per Income-tax Profit 60,000 x 20% = Rs. 12,000

Tax as per MAT 3,50,000 x 7.50% = Rs. 26,250

Tax expense= Current Tax +Deferred Tax

Rs. 1,20,000 = Rs. 12,000+ Deferred tax

Therefore, Deferred Tax liability as on 31-03-20X1

= Rs. 1,20,000 – Rs. 12,000 = Rs. 1,08,000

Amount of tax to be debited in Profit and Loss account for the year 31-03-20X1

Current Tax + Deferred Tax liability + Excess of MAT over current tax

= Rs. 12,000 + Rs. 1,08,000 + Rs. 14,250 (26,250 – 12,000) = Rs. 1,34,250

Illustration 3

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of Rs. 2,00,000 for the year ending 31.3.20X1. For the years ending 31.3.20X2 and 31.3.20X3, it made profits of Rs. 1,00,000 and Rs. 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 31.3.20X1, 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 20X2 and 20X3 for tax purposes. Prepare a statement of Profit and Loss for the years ending 20X1, 20X2 and 20X3.

(PYP Sept 24)

Solution:

Statement of Profit and Loss

	31.3.20X1 Rs.	31.3.20X2 Rs.	31.3.20X3 Rs.
Profit (Loss)	(2,00,000)	1,00,000	1,20,000
Less: Current tax (20,000 x 40%)			(8,000)
Deferred tax:			
Tax effect of timing differences originating during the year (2,00,000 x 40%)	80,000		
Tax effect of timing differences reversed/adjusted during the year (1,00,000 x 40%)		(40,000)	(40,000)
Profit (Loss) After Tax Effect	(1,20,000)	60,000	72,000

Illustration 4

Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognises revenue from these contracts on percentage of completion method for financial statements during 20X0-20X1, 20X1-20X2 and 20X2-20X3 for Rs. 11,00,000, Rs. 16,00,000 and Rs. 21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognised revenue of Rs. 7,00,000, Rs. 18,00,000 and Rs. 23,00,000 for the years 20X0-20X1, 20X1-20X2 and 20X2-20X3 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 20X0-20X1, 20X1- 20X2 and 20X2-20X3.

Solution:

Calculation of Deferred Tax Asset/Liability in Omega Limited

Year	Accounting Income	Taxable Income	Timing Difference	Timing Difference (balance)	Deferred Tax	Deferred Tax Liability (balance)
20X0- 20X1	11,00,000	7,00,000	4,00,000	4,00,000	1,40,000	1,40,000
20X1- 20X2	16,00,000	18,00,000	(2,00,000)	2,00,000	(70,000)	70,000
20X2- 20X3	21,00,000	23,00,000	(2,00,000)	NIL	(70,000)	NIL
	48,00,000	48,00,000				

Test Your Knowledge

1. **As per AS 22 on 'Accounting for Taxes on Income', tax expense is:**
   (a) Current tax + deferred tax charged to profit and loss account
   (b) Current tax-deferred tax credited to profit and loss account
   (c) Either (a) or (b)
   (d) Deferred tax charged to profit and loss account

2. **G Ltd. has provided the following information: Depreciation as per accounting records = Rs.2,00,000 Depreciation as per tax records = Rs. 5,00,000**
   There is adequate evidence of future profit sufficiency.
   How much deferred tax asset/liability should be recognized as transition adjustment when the tax rate is 45%?
   (a) Deferred Tax asset = Rs. 2,70,000.
   (b) Deferred Tax asset = Rs. 1,35,000.
   (c) Deferred Tax Liability = Rs. 2,70,000
   (d) Deferred Tax Liability = Rs. 1,35,000.

3. **State which of the followings statements are correct:**
   (1) There are no pre-conditions required to recognize deferred tax liability,
   (2) Deferred tax asset under all circumstances can only be created if and only if there is reasonable certainty that future taxable income will arise.
   (a) Both are correct.
   (b) Only (1) is correct.
   (c) Only (2) is correct.
   (d) None of the statements are correct.

4. **Which of the following statement are incorrect:**
   (a) Only timing differences result in creation of deferred tax.
   (b) Permanent differences do not result in recognition of deferred tax.
   (c) The tax rate used for measurement of deferred tax is substantively enacted tax rate.
   (d) The entity has to recognize deferred tax liability/asset arising out of timing difference. There are no conditions which are required to evaluated for their recognition.

Answer to the Multiple Choice Questions

1.	(c)	2.	(d)	3.	(a)	4.	(d)

Theoretical Questions

5. Write short note on Timing differences and Permanent differences as per AS 22.

Answer:

In current practices, companies, in general, prepare books of accounts as per Companies Act, 2013 generating Accounting Profit/Loss and Income-tax Act, 1961 generating Taxable Profit/Loss. Accounting income and taxable income for a period are seldom the same. Permanent differences are those which arise in one period and do not reverse subsequently. For e.g., an income exempt from tax or an expense that is not allowable as a deduction for tax purposes. Timing differences are those which arise in one period and are capable of reversal in one or more subsequent periods. For e.g., Depreciation etc.

Scenario Based Questions

6. Y Ltd. is a full tax free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference is INR 200 lakhs and INR 400 lakhs respectively which will result in a tax liability in year 1 and 2. From the third year it is expected that the timing difference would reverse each year by INR 10 lakhs. Assuming tax rate of 40% find out the deferred tax liability at the end of the second year and any charge to the Profit and Loss account.

Answer:

As per AS 22, 'Accounting for Taxes on Income', 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 Income- tax 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. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of 200 lakhs timing difference due to depreciation, difference amounting 80 lakhs (10 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognised. However, for 120 lakhs (200 lakhs – Rs. 80 lakhs), deferred tax liability will be recognised for 48 lakhs (40% of 120 lakhs) in first year. In the second year, the entire amount of timing difference of Rs. 400 lakhs will reverse only after tax holiday period and hence, will be recognised in full. Deferred tax liability amounting 160 lakhs (40% of 400 lakhs) will be created by charging it to profit and loss account and the total balance of deferred tax liability account at the end of second year will be 208 lakhs (48 lakhs + 160 lakhs).

7. Ultra Ltd. has provided the following information: Depreciation as per accounting records =INR 4,00,000 Depreciation as per tax records =INR 10,00,000
Unamortized preliminary expenses as per tax record = INR 30,000
There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment when the tax rate is 50%?

Answer:

Calculation of difference between taxable income and accounting income

Particulars	Amount (Rs.)
Excess depreciation as per tax Rs. (10,00,000 – 4,00,000)	6,00,000
Less: Expenses unamortized in tax records	(30,000)
Timing difference	5,70,000

Tax expense is more than the current tax due to timing difference. Therefore deferred tax liability = 50% x 5,70,000 = 2,85,000

8. Saras Ltd. closes its books as on 31st March 20X2. They have accrued Rs. 5,00,000 towards GST Liability for the month of March 20X2 by debiting their Profit and loss statement which is expected to be paid off by 21st April 20X2 . As per the provisions of Section 43B of the Income Tax Act, 1961 – Any expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.) accrued in the statement of profit and loss on mercantile basis will be allowed for tax purposes in subsequent years on payment basis only. Assuming a Tax rate of 30% determine the Deferred Tax Asset/Liability as at 31st March 20X2.

Answer:

Calculation of difference between taxable income and accounting income

Particulars	Amount (Rs.)
GST Liability debited in books	5,00,000
Less: GST Liability allowed under Income Tax Act (Section 43B)	Nil
Timing difference	5,00,000

Tax expense is less than the current tax due to timing difference. Therefore, deferred tax Asset = 30% x 5,00,000 = 1,50,000

9. ABC Company limited had an investment in Venture Capital amounting Rs. 10 Crores. Venture capital in turn had invested in the below portfolio companies (New Start- ups) on behalf of ABC Limited:

Portfolio Companies	Amount of investment (Rs. in Crores)
Oscar Limited	2
Zee Limited	3
Star Limited	4
Sony Limited	1
Total	10

During the FY 2019-2020, Venture Capital had sold their investment in Star Limited and realised an amount of Rs. 8 Crores on sale of shares of star Limited and entire proceeds of Rs. 8 Crores have been transferred by Venture Capital to ABC Company Limited.

The accounts manager has received the following additional information from venture capital on 31.03.2020:

(1) 8 Crores has been deducted from the cost of investment and carrying amount of investment as at year end is 2 Crores.

(2) Company had to pay a capital gain tax @ 20% on the net sale consideration of Rs. 4 Crores.

(3) Due to COVID-19, the remaining start- ups (i.e. Oscar Limited, Zee Limited, and Sony Limited) are not performing well and will soon wind up their operations. Venture capital is monitoring the situation and if required they will provide an impairment loss in June 2020 Quarter.

You need to suggest the accounts manager what should be the correct accounting treatment as per AS 22 "Accounting for Taxes on Income".

Answer:

As company had to pay capital gain tax @ 20% on the net sale consideration as per income tax laws, the company has to recognise a current tax liability of 0.8 Crores computed as under:

Particulars	Amount (Rs. in Crores)
Sales Consideration	8
Cost of Investment	4
Net gain on Sale	4
Tax @ 20%	0.8

As per AS 22, Timing differences are those 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.

Particulars	Amount (Rs. in Crores)	Rationale
Taxable Income	4	As per income tax laws
Accounting Income	Nil	As the same is deducted from the cost of investment
Timing Difference	4	

As per AS 22, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Since in current scenario, due to Covid 19 the portfolio companies are not performing well, thus the company may not have sufficient future taxable income which will reverse deferred tax assets.

Therefore, the company should not recognise DTA of Rs. 0.8 Crores and company should recognise only current tax liability of Rs. 0.8 Crores.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: ABC Ltd. prepares its accounts annually on 31st March. On 1st April, 2022, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of Rs. 2,00,000 each year and corporate tax rate is 40 percent each year.

The purchase of machine at a cost of Rs. 1,50,000 in 2022 gives rise to a tax saving of Rs. 60,000. The corporate tax rate has been assumed to be same in each of the three years. Calculate deferred tax and pass necessary journal entries.

What will be the amount of deferred tax, if the substantively enacted tax rates for 2022, 2023 and 2024 are 40%, 35% and 38% respectively. (RTP Jan 25)

Answer:

If the cost of machine is spread over three years of its life for accounting purposes, the amount of the tax saving should also be spread over the same period as shown below:

Statement of Profit and Loss

(for the three years ending 31st March, 2022, 2023, 2024)

	(Rs. in thousand)		
	2022	**2023**	**2024**
Profit before depreciation and taxes	200	200	200
Less: Depreciation for accounting purposes	50	50	50
Profit before taxes	150	150	150
Less: Tax expense			
Current tax:			
0.40 x (200 -150)		20	
0.40 x 200	80		80
Deferred tax:			
Tax effect of timing differences originating during the year leading to DTL			
0.40 (150-50)	40		
Tax effect of timing differences reversing during the year			
0.40 (0-50)	-	(20)	(20)
Tax expense	60	60	60
Profit after tax	90	90	90
Net timing differences	100	50	0
Deferred tax liability balance	40	20	0

In 2022, the amount of depreciation allowed for tax purposes exceeds the amount of depreciation charged for accounting purpose by Rs. 1,00,000 and, therefore, taxable income is lower than the accounting income. This gives rise to a deferred tax liability of Rs. 40,000. In 2023 and 2024 accounting income is lower than taxable income because the amount of depreciation charged for accounting purposes exceeds the amount of depreciation allowed for tax purposes by Rs. 50,000 each year. Accordingly, deferred tax liability is reduced by Rs. 20,000 each in both the years. As may be seen, tax expense in based on the accounting income of each period.

In 2022, the profit and loss account is debited and deferred tax liability account is credited with the amount of tax on the originating timing difference of Rs. 1,00,000 while in each of the following two

years, deferred tax liability account is debited and profit and loss account is credited with the amount of tax on the reversing timing difference of Rs. 50,000.

The following Journal entries will be passed:

Year 2022			
Profit and Loss A/c	Dr.	20,000	
To Current tax A/c			20,000
(Being the amount of taxes payable for the year 2022 provided for)			
Profit and Loss A/c	Dr.	40,000	
To Deferred tax liability A/c			40,000
(Being the deferred tax liability created for originating timing difference of Rs. 1,00,000)			
Year 2023			
Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 2023 provided for)			
Deferred tax liability A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			
Year 2024			
Profit and Loss A/c	Dr.	80,000	
To Current tax A/c			80,000
(Being the amount of taxes payable for the year 2024 provided for)			
Deferred tax liability A/c	Dr.	20,000	
To Profit and Loss A/c			20,000
(Being the deferred tax liability adjusted for reversing timing difference of Rs. 50,000)			

Presentation:

In the year 2022, the balance of deferred tax account i.e. Rs. 40,000 would be shown separately from the current tax payable for the year in terms of paragraph 30 of AS 22. In the year 2023, the balance of deferred tax liability account would be Rs. 20,000 and be shown separately from the current tax payable for the year as in year 2022. In year 2024, the balance of deferred tax liability account would be nil.

If the rate of tax changes, it would be necessary for the enterprises to adjust the amount of deferred tax liability carried forward by applying the tax rate that has been enacted or substantively enacted by the balance sheet date on accumulated timing differences at the end of the accounting year

The amount of deferred tax liability would be computed as follows:

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

31st March, 2022 = 0.40 (1,00,000) = Rs. 40,000

31st March, 2023 = 0.35 (50,000) = Rs. 17,500

31st March, 20224 = 0.38 (Zero) = Rs. Zero

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

31st March, 2022 Debit = Rs. 40,000

31st March, 2023 (Credit) = Rs. (22,500)

31st March, 2024 (Credit) = Rs. (17,500)

Question 2: Amber Limited purchases a building at a cost of ₹ 20,00,000 on 1st April 2021 its useful life is four years and an expected scrap value is zero. Depreciation is allowed @ 50% in 1st year and rest balance in 2nd year for Tax purpose. Straight-line method is considered for accounting purpose. Amber Limited profit before depreciation and taxes are as follow:

Year	Profit (in ₹)
2021-2022	18,00,000
2022-2023	22,00,000
2023-2024	25,00,000
2024-2025	30,00,000

The corporate tax rate is 30% in all 4 years.

You are required to calculate Current Tax, Deferred Tax Assets/Liability and Tax Expense for each year. (PYP Sep 25 5M)

Answer:

As per AS 22 "Accounting for Taxes on Income", computation of Current Tax, Deferred Tax Liability (DTL), and Total Tax Expense of Amber Limited is as under:

	2021-2022 (₹)	2022-2023 (₹)	2023-2024 (₹)	2024-2025 (₹)
Profit before depreciation and taxes	18,00,000	22,00,000	25,00,000	30,00,000
Less: Depreciation for accounting purposes	5,00,000	5,00,000	5,00,000	5,00,000
Profit before Taxes (i)	13,00,000	17,00,000	20,00,000	25,00,000
Less: Tax Expenses				
(a) Current tax for the year	2,40,000	3,60,000	7,50,000	9,00,000
(b) Deferred Tax Liability/ Asset(b)	1,50,000	1,50,000	(1,50,000)	(1,50,000)
Tax expense (a+b) (ii)	**3,90,000**	**5,10,000**	**6,00,000**	**7,50,000**
Profit after tax (i) – (ii)	9,10,000	11,90,000	14,00,000	17,50,000

Working notes:

1. Calculation of current tax at 30%

Year	Taxable Income	Current Tax (₹)
2021-22	8,00,000(18,00,000-10,00,000)	2,40,000
2022-23	12,00,000(22,00,000-10,00,000)	3,60,000
2023-24	25,00,000	7,50,000
2024-25	30,00,000	9,00,000

2. Calculation of Timing Difference and Deferred Tax Assets/Liability

Year	Timing Difference (Tax Depreciation- Accounting Depreciation)	DTL/(DTA) Deferred Tax = Timing Difference × 30%
2021-22	10,00,000 -5,00,000= 5,00,000	1,50,000
2022-23	10,00,000 -5,00,00=5,00,000	1,50,000
2023-24	0 – 5,00,000= (5,00,000)	(1,50,000)
2024-25	0- 5,00,000 = (5,00,000)	(1,50,000)

AS – 24: Discontinuing Operations

Test Your Knowledge

Multiple Choice Questions

1. **AB decided to dispose of its Clothing division as part of its long-term strategy.**
   (a) Date of Board approval - 1st March 20X1;
   (b) Date of formal announcement made to affected parties - 15th March 20X1.
   (c) Date of Binding Sale agreement – 1st July 20X1;
   (d) Reporting date – 31st March 20X1
   The date of initial disclosure event would be:
   (a) 1st March 20X1
   (b) 15th March 20X1
   (c) 31st March 20X1
   (d) 31st July 20X1

2. **To qualify as a component that can be distinguished operationally and for financial reporting purposes, the condition(s) to be met is (are):**
   (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.
   (d) All of the above

3. Identify which of the following statements is incorrect?
   (a) A discontinuing operation is a component of an enterprise that represents a separate major line of business or geographical area of operations.
   (b) A discontinuing operation is a component of an enterprise that can be distinguished operationally and for financial reporting purposes.
   (c) A discontinuing operation is a component of an enterprise that may or may not be distinguished operationally and for financial reporting purposes.
   (d) A discontinuing operation may be disposed of in its entirety or piecemeal, but always pursuant to an overall plan to discontinue the entire component.

4. Identify the incorrect statement.
   (a) Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.
   (b) The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 would always raise a question regarding the enterprise's ability to continue as a going concern.
   (c) For recognising and measuring the effect of discontinuing operations, AS 24 does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.
   (d) An enterprise shall include a description of the discontinuing operation, in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs.

Answers to the Multiple Choice Questions

1.	(b)	2.	(d)	3.	(c)	4.	(b)

Theoretical Questions

5.

(i) What are the disclosure and presentation requirements of AS 24 for discontinuing operations?

(ii) Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.

Answer:

(i) An enterprise should include prescribed information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15 of AS 24) occurs. For details, please refer Section 6.5 of this Chapter above.

(ii) Examples of activities that do not necessarily satisfy criterion (a) of the definition, but that might do so in combination with other circum- stances, 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 enterprise should include prescribed information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15 of AS 24) occurs. For details, please refer Section 6.5 of this Chapter above.

(iii) Examples of activities that do not necessarily satisfy criterion (a) 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.

6. What are the initial disclosure requirements of AS 24 for discontinuing operations?

Answer:

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:

(i) A description of the discontinuing operation(s)

(ii) The business or geographical segment(s) in which it is reported as per AS 17.

(iii) The date and nature of the initial disclosure event.

(iv) The date or period in which the discontinuance is expected to be completed if known or determinable

(v) The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled.

(vi) The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period.

(vii) 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.

(viii) The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

Scenario Based Questions

7. Rohini Limited is in the business of manufacture of passenger cars and commercial vehicles. The Company is working on a strategic plan to close the production of passenger cars and to produce only commercial vehicles over the coming 5 years. However, no specific plans have been drawn up for sale of neither the division nor its assets. As part of its prospective plan it will reduce the production of passenger cars by 20% annually. It also plans to establish another new factory for the manufacture of commercial vehicles and transfer surplus employees in a phased manner.

You are required to comment:

(i) If mere gradual phasing out in itself can be considered as a 'discontinuing operation' within the meaning of AS-24.

(ii) If the Company passes a reSolution: to sell some of the assets in the passenger car division and also to transfer few other assets of the passenger car division to the new factory, does this trigger the application of AS-24?

(iii) Would your answer to (ii) above be different if the Company resolves to sell the assets of the passenger car division in a phased but time bound manner? (MTP May 25 S2 7M)

Answer:

i) 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; and

(c) that can be distinguished operationally and for financial reporting purposes.

Mere gradual phasing out is not considered as discontinuing operation as defined under AS 24, 'Discontinuing Operations'.

Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

(i) Gradual or evolutionary phasing out of a product line or class of service;

(ii) Shifting of some production or marketing activities for a particular line of business from one location to another; and

(iii) Closing of a facility to achieve productivity improvements or other cost savings. In this case, it cannot be considered as Discontinuing Operation as per AS-24 as the companies' strategic plan has no final approval from the board through a reSolution: and there is no specific time bound activities like shifting of assets and employees. Moreover, the new segment i.e. commercial vehicle production line in a new factory has not started.

ii) No, the reSolution: is silent about stoppage of the Car segment in definite time period. Though, sale of some assets and some transfer proposal were passed through a reSolution: to the new factory, but the closure road map and new segment starting roadmap are missing.

Hence AS 24 will not be applicable and it cannot be considered as Discontinuing operations.

iii) Yes, phased and time bound program resolved in the board clearly indicates the closure of the passenger car segment in a definite time frame and will constitute a clear roadmap.

Hence this action will attract compliance of AS 24 and it will be considered as Discontinuing Operations as per AS-24.

8. A consumer goods producer has changed the product line as follows:

	Dish washing Bar (Per month)	Clothes washing Bar (Per month)
January 2021 - September 2021	2,00,000	2,00,000
October 2021 - December 2021	1,00,000	3,00,000
January 2022 - March 2022	Nil	4,00,000

The company has enforced a gradual enforcement of change in product line on the basis of an overall plan. The Board of Directors has passed a reSolution: in March 2021 to this effect. The company follows calendar year as its accounting year.

You required to advise the company whether it should be treated as discontinuing operation or not as per AS 24?

Answer:

As per AS 24 'Discontinuing Operations', a discontinuing operation is a component of an enterprise:

(i) that the enterprise, pursuant to a **single plan**, is:

(1) disposing of substantially in its entirety,

(2) disposing of piecemeal, or

(3) terminating through abandonment; and

(ii) that represents a separate **major line** of business or geographical area of operations; and

(iii) that can be distinguished operationally and for financial reporting purposes.

As per provisions of the standard, business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations, they can occur in connection with a discontinuing operation. Examples of activities that do not necessarily satisfy criterion of discontinuing operation are gradual or evolutionary phasing out of a product line or class of service, discontinuing, even if relatively abruptly, several products within an ongoing line of business;

In the given case, the company has enforced a gradual enforcement of change in product line and does not represent a separate major line of business and hence is not a discontinued operation. If it were a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(i) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(ii) the enterprises board of directors or similar governing body has both approved a detailed, formal plan for discontinuance and made an announcement of the plan.

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1:

(i) What are the disclosure and presentation requirements of AS 24 for discontinuing operations? (RTP May 20, May 22, Old & New SM)

(ii) Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances. (RTP May 22)

Answer:

(i) An enterprise should include prescribed information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs

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

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

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.

Other disclosures

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 recognized 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.

Updating the disclosures

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. 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.

Separate disclosure for each discontinuing operation Any disclosures required by AS 24 should be presented separately for each discontinuing operation.

Presentation of the required disclosures

The above 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 recognized on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

(ii) Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operations.

Examples of activities that do not necessarily satisfy criterion (a) 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.
e.

Question 2: What is the disclosure requirement in interim financial reports as per AS 24 for discontinuing operations? (RTP Nov'22)

Answer:

Disclosure in interim financial reports

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.

Question 3: A consumer goods producer has changed the product line as follows:

	Dish washing Bar (Per month)	Clothes washing Bar (Per month)
January 2021 - September 2021	2,00,000	2,00,000

October 2021 - December 2021	1,00,000	3,00,000
January 2022 - March 2022	Nil	4,00,000

The company has enforced a gradual enforcement of change in product line on the basis of an overall plan. The Board of Directors has passed a reSolution: in March 2021 to this effect. The company follows calendar year as its accounting year.

You required to advise the company whether it should be treated as discontinuing operation or not as per AS 24? (RTP May '23)

Answer:

As per AS 24 'Discontinuing Operations', a discontinuing operation is a component of an enterprise:

(i) that the enterprise, pursuant to a single plan, is:

(1) disposing of substantially in its entirety,

(2) disposing of piecemeal, or

(3) terminating through abandonment; and

(ii) that represents a separate major line of business or geographical area of operations; and

(iii) that can be distinguished operationally and for financial reporting purposes.

As per provisions of the standard, business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations, they can occur in connection with a discontinuing operation. Examples of activities that do not necessarily satisfy criterion of discontinuing operation are gradual or evolutionary phasing out of a product line or class of service, discontinuing, even if relatively abruptly, several products within an ongoing line of business;

In the given case, the company has enforced a gradual enforcement of change in product line and does not represent a separate major line of business and hence is not a discontinued operation. If it were a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(i) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(ii) the enterprises board of directors or similar governing body has both approved a detailed, formal plan for discontinuance and made an announcement of the plan.

AS – 25: Interim Financial Reporting

Illustrations

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 ended on 30th June, 20X1 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 Rs. 10 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore, the 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	(Rs. In crores)	
Result of first quarter ended 30th June, 20X1		
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, 20X1 and it makes its reports quarterly. However, for the purpose of tax, year ends on 31st March every year. For the Accounting year from 1-10-20X0 to 30-9-20X1, the quarterly income is as under:

1st quarter ending on 31st December, 20X0	Rs. 200 crores
2nd quarter ending on 31st March, 20X1	Rs. 200 crores
3rd quarter ending on 30th June, 20X1	Rs. 200 crores
4th quarter ending on 30th September, 20X1	Rs. 200 crores
Total	Rs. 800 crores

Average actual tax rate for the financial year ending on 31st March, 20X1 is 20% and for financial year ending 31st March, 20X2 is 30%. Calculate tax expense for each quarter.

Solution:

Calculation of tax expense

1st quarter ending on 31st December, 20X0	200 x 20%	Rs. 40 lakhs
2nd quarter ending on 31st March, 20X1	200 x 20%	Rs. 40 lakhs
3rd quarter ending on 30th June, 20X1	200 x 30%	Rs. 60 lakhs
4th quarter ending on 30th September, 20X1	200 x 30%	Rs. 60 lakhs

Illustration 3

Accountants of Poornima Ltd. showed a net profit of Rs. 7,20,000 for the third quarter of 20X1 after incorporating the following:

(i) Bad debts of Rs. 40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.

(ii) Extra ordinary loss of Rs. 35,000 incurred during the quarter has been fully recognized in this quarter.

(iii) Additional depreciation of Rs. 45,000 resulting from the change in the method of charge of depreciation assuming that Rs. 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 Rs. 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) Rs. 20,000 to the next quarter. Therefore, Rs. 20,000 should be deducted from Rs. 7,20,000. The treatment of extra-ordinary loss of Rs. 35,000 being recognized in the same quarter is correct.

Recognising additional depreciation of Rs. 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 Rs. 7,00,000 (Rs. 7,20,000 – Rs. 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 30th June	30th September	31st December	31st March
15%	15%	50%	25%

For the First quarter ending 30th June, 20X1, I - Corp. gives you the following information:

	Rs. 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 Rs. 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 and that 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 30th June, 20X1

		(Rs. 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 recognized when they are earned and incurred respectively. As per 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 Rs. 21 crores is not tenable as expenditures are uniform throughout all quarters.

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Test Your Knowledge

1. **AS 25 mandates the following in relation to interim financial reports.**
   (a) which entities should publish interim financial reports.
   (b) how frequently it should publish interim financial reports.
   (c) how soon it should publish after the end of interim period.
   (d) none of the above.

2. The standard defines Interim financial Report as a financial report for an interim period that contains a set of_____financial statements.
   (a) Complete
   (b) Condensed
   (c) Financial statement similar to annual
   (d) Either complete or condensed

3. ABC Limited has reported Rs. 85,000 as per tax profit in first quarter and expects a loss of Rs. 25,000 each in subsequent quarters. It has corporate tax rate slab of 20% on the first Rs. 20,000 earnings and 40% on all additional earnings. Calculate tax expenses that should report in first quarter interim financial report.
   (a) Rs. 17,000
   (b) Rs. 30,000
   (c) Rs. 2,000
   (d) AS 25 does not mandate to report tax expenses

4. An entity prepares quarterly interim financial reports in accordance with AS 25. The entity is engaged in sale of mobile phones and normally 5% of customers claim on their warranty. The provision in the first quarter was calculated as 5% of sales to date, which was Rs.10 million. However, in the second quarter, a fault was found and warranty claims were expected to be 10% for the whole of the year. Sales in the second quarter were Rs. 15 million. What would be the provision charged in the second quarter's interim financial statements?
   (a) Rs. 1 million
   (b) Rs. 2 million
   (c) Rs. 1.25 million
   (d) Rs. 1.5 million

Answers to the Multiple Choice Questions

1.	(d)	2.	(d)	3.	(a)	4.	(b)

Theoretical Questions

5. What are the periods for which Interim financial Statements are required to be presented? You are required to answer your question in light of preparation of financial statements for the period ended and as at 31st December, 20X1. The Financial Year is FY 20X1 - X2.

Answer:

As per Accounting Standard 25, Interim reports should include interim financial statements (condensed or complete) for periods as given below.

Statement	Current period	Comparative period
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

In light of the above, following periods needs to be covered in interim financial statements for the period ended and as at 31st December, 20X1:

Balance Sheet	as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year (As at 31 December 20X1 and 31 March 20X1).
Statements of Profit and Loss	for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year. (for 3 months and 9 months i.e., year to date ended 31 December 20X1 and same for 31 December 20X0 being comparative period).
Cash Flow Statement	cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year. (year to date i.e., 1 April 20X1 to 31 December 20X1 and 1 April 20X0 to 31 December 20X0).

6. Whether quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises meet the definition of 'interim financial report' as per AS 25 and the provisions of AS 25 should be applied on the same?

Answer:

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.

The quarterly financial results presented under Clause 41 of the Listing Agreement 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.

7. Whether the impairment loss recognized on property plant and equipment in first quarter of the financial year can be reversed in the second quarter in that financial year?

Answer:

As per AS 25, 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. In light of the same, the impairment loss recognized in one quarter can be reversed in the another quarter of the financial year, if favourable indicator exists as per AS 28 and the recoverable amount increased in comparison to earlier period.

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Scenario Based Questions

8. In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?

Answer:

Accounting Standard 25 suggests that provision in respect of defined benefit schemes like pension and gratuity for an interim period should be calculated based on the year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.

9. On 30th June, 20X1, Asmitha Ltd. incurred Rs. 2,00,000, net loss from disposal of a business segment. Also, on 31st July, 20X1, the company paid Rs. 60,000 for property taxes assessed for the calendar year 20X1. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interim period ended on 30th September, 20X1.

Answer:

According to Para 10 of AS 25 "Interim Financial Reporting", 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. As at 30th September, 20X1, Asmitha Ltd would report the entire amount of Rs. 2,00,000 as loss on the disposal of its business segment since the loss was incurred during interim period. A cost charged as an expense in an annual period should be allocated to interim periods on accrual basis. Since Rs. 60,000 Property tax payment relates to entire calendar year 20X1, Rs. 30,000 would be reported as an expense for six months ended on 30th September, 20X1 while out of the remaining Rs. 30,000, Rs. 15,000 for January, 20X1 to March, 20X1 should be shown as payment of the outstanding amount of previous year and another Rs. 15,000 related to quarter October, 20X1 to December, 20X1 would be reported as prepaid expenses.

10. An enterprise reports quarterly, estimates an annual income of Rs. 10 lakhs. Assume tax rates on 1st Rs. 5,00,000 at 30% and on the balance income at 40%.
The estimated quarterly income are Rs. 75,000, Rs. 2,50,000, Rs. 3,75,000 and Rs. 3,00,000.
Calculate the tax expense to be recognized in each quarter.

Answer:

As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

		Rs.
Estimated Annual Income	(A)	10,00,000
Tax expense:		
30% on Rs. 5,00,000		1,50,000
40% on remaining Rs. 5,00,000		2,00,000
	(B)	3,50,000

Weighted average annual income tax rate = B / A = 3,50,000 / 10,00,000 = 35%

Tax expense to be recognized in each of the quarterly reports	Rs.
Quarter I – Rs.75,000 x 35%	26,250
Quarter II - Rs.2,50,000 x 35%	87,500
Quarter III - Rs.3,75,000 x 35%	1,31,250
Quarter IV - Rs.3,00,000 x 35%	1,05,000
Rs.10,00,000	3,50,000

11. Antarbarti Limited reported a Profit Before Tax (PBT) of Rs. 4 lakhs for the third quarter ending 30-09-20X1. On enquiry you observe the following. Give the treatment required under AS 25:

(i) Dividend income of Rs. 4 lakhs received during the quarter has been recognized to the extent of Rs. 1 lakh only.

(ii) 80% of sales promotion expenses Rs. 15 lakhs incurred in the third quarter has been deferred to the fourth quarter as the sales in the last quarter is high.

(iii) In the third quarter, the company changed depreciation method from WDV to SLM, which resulted in excess depreciation of Rs. 12 lakhs. The entire amount has been debited in the third quarter, though the share of the third quarter is only Rs. 3 lakhs.

(iv) Rs. 2 lakhs extra-ordinary gain received in third quarter was allocated equally to the third and fourth quarter.

(v) Cumulative loss resulting from change in method of inventory valuation was recognized in the third quarter of Rs. 3 lakhs. Out of this loss Rs. 1 lakh relates to previous quarters.

(vi) Sale of investment in the first quarter resulted in a gain of Rs. 20 lakhs. The company had apportioned this equally to the four quarters.

Prepare the adjusted profit before tax for the third quarter.

Answer:

As per para 36 of AS 25 "Interim Financial Reporting", seasonal or occasional revenue and cost within a financial year should not be deferred as of interim date until it is appropriate to defer at the end of the enterprise's financial year. Therefore, dividend income, extra-ordinary gain, and gain on sale of investment received during 3rd quarter should be recognised in the 3rd quarter only. Similarly, sales promotion expenses incurred in the 3rd quarter should also be charged in the 3rd quarter only.

Further, as per AS 10, Property, Plant and Equipment, if there is change in the depreciation method, such a change should be accounted for as a change in accounting estimate in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, and applied prospectively. Therefore, no adjustment would be required due to change in the method of depreciation.

Accordingly, the adjusted profit before tax for the 3rd quarter will be as follows:

Statement showing Adjusted Profit Before Tax for the third quarter

	(Rs. in lakhs)
Profit before tax (as reported)	4
Add: Dividend income Rs. (4-1) lakhs	3
Excess depreciation charged in the 3rd quarter, due to change in the method	-
Extra ordinary gain Rs. (2-1) lakhs	1
Cumulative loss due to change in the method of inventory valuation should be applied retrospectively Rs. (3-2) lakhs	1
	9

Less: Sales promotion expenses (80% of Rs. 15 lakhs)	(12)
Gain on sale of investment (occasional gain should not be deferred)	(5)
Adjusted Profit before tax for the third quarter	(8)

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: XY Limited reported a Profit Before Tax (PBT) of ₹ 18 lakhs for the third quarter ending 31st December 2024. Following observations are noted;

(i) Dividend income of ₹ 8 lakhs received during the quarter has been recognized to the extent of ₹ 2 lakh only.

(ii) Sales promotion expenses ₹ 15 lakhs incurred in the third quarter, 70% has been deferred to the fourth quarter as the sales in the last quarter is high.

(iii) In the third quarter, the company changed depreciation method from WDV to SLM, which resulted in excess depreciation of ₹ 4 lakhs. The entire amount has been debited in the third quarter, though the share of the third quarter is only ₹ 1 lakhs.

(iv) ₹ 3 lakhs extra-ordinary gain received in third quarter was allocated equally to the third and fourth quarter.

(v) Cumulative loss resulting from change in method of inventory valuation was recognized in the third quarter of ₹ 5 lakhs. Out of this loss ₹ 2 lakhs relates to previous quarters.

(vi) Sale of investment in the first quarter resulted in a gain of ₹ 30 lakhs. The company had apportioned this equally to the four quarters.

Calculate the result of the third quarter as per AS 25 and also comment on the company's view on each observation. (PYP May 25 7M)

Answer:

As per para 36 of AS 25 "Interim Financial Reporting", seasonal or occasional revenue and cost within a financial year should not be deferred as of interim date until it is appropriate to defer at the end of the enterprise's financial year

Comments on observations:

(i) Dividend income received during 3rd quarter should be recognised in the 3rd quarter only.

(ii) Sales promotion expenses cannot be deferred on the basis that fourth quarter has more sales. This expense should be recognized in 3rd quarter only.

(iii) Further, as per AS 10, Property, Plant and Equipment, if there is change in the depreciation method, such a change should be accounted for as a change in accounting estimate in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, and applied prospectively. Therefore, no adjustment would be required due to change in the method of depreciation.

(iv) Extra ordinary gain of ₹ 3 lakhs should be wholly recognized in 3rd quarter only.

(v) Loss of ₹ 2 lakhs belong to previous quarters and not 3rd quarter, so it should not be deducted from the profit of 3rd quarter.

(vi) Gain on sale of investment is in the nature of occasional gain, so it cannot be deferred and hence the amount of ₹ 7.5 lakhs considered as income of 1st quarter, will be reversed from the profit of the 3rd quarter.

Accordingly, the adjusted profit before tax for the 3rd quarter will be as follows:

Statement showing Adjusted Profit Before Tax for the third quarter

	(₹)
Profit before tax (as reported)	18,00,000
Add: Dividend income ₹ (8,00,000 - 2,00,000)	6,00,000
Excess depreciation charged in the 3rd quarter, due to change in the method	-
Extra ordinary gain ₹ (3,00,000-1,50,000)	1,50,000

Cumulative loss due to change in the method of inventory valuation should be applied retrospectively ₹ (5,00,000-3,00,000)	2,00,000
	27,50,000
Less: Sales promotion expenses (70% of ₹ 15 lakhs)	(10,50,000)
Gain on sale of investment (occasional gain should not be deferred)	(7,50,000)
Adjusted Profit before tax for the third quarter	9,50,000

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AS – 26: Intangible Assets

Illustrations

Illustration 1

ABC Ltd. developed know-how by incurring expenditure of Rs.20 lakhs, The know-how was used by the company from 1.4.20X1. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.20X8. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.20X8. (PYP Sept 24)

Solution:

Journal Entry

		Rs.	Rs.
Profit and Loss A/c (Prior period item)	Dr.	12,00,000	
Amortization A/c	Dr.	2,00,000	
To Know-how A/c*			14,00,000
[Being amortization of 7 years (out of which amortization of 6 years charged as prior period item)]			

Illustration 2

The company had spent Rs.45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 20X1-20X2, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 20X2.

Solution:

In the given case, the company spent Rs.45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/benefit because of the failure of the product. Thus, according to AS 26 'Intangible Assets', the company should charge the total amount of Rs.45 lakhs as an expense in the profit and loss account.

Illustration 3

A company with a turnover of Rs.250 crores and an annual advertising budget of Rs.2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of Rs.25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of Rs.2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct?

Solution:

According to AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset".

AS 26 mentions that expenditure on advertising and promotional activities should be recognised as an expense when incurred.

In the given case, advertisement expenditure of Rs.2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of Rs.25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised.

Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of Rs.2 crores to the Profit and Loss account of the year is correct.

Test Your Knowledge

1. **Which of the following is not covered within the scope of AS 26?**
   - **(a)** Intangible assets held-for-sale in the ordinary course of business
   - **(b)** Assets arising from employee benefits
   - **(c)** (a) & (b) both
   - **(d)** Research and development activities

2. **Intangible asset is recognised if it:**
   - **(a)** meets the definition of an intangible asset
   - **(b)** is probable that future economic benefits will flow
   - **(c)** the cost can be measured reliably
   - **(d)** meets all of the above parameters

3. **Sun Limited has purchased a computer with various additional software. These are integral part of the computer. Which of the following are true in the context of AS 26:**
   - **(a)** Recognise Computer and software as tangible asset
   - **(b)** Recognise tangible and intangible separately
   - **(c)** Recognise computer and software as intangible asset
   - **(d)** Does not recognize the software as an asset.

4. **Hexa Ltd developed a technology to enhance the battery life of mobile devices. Hexa has capitalised development expenditure of Rs.5,00,000. Hexa estimates the life of the technology developed to be 3 years but the company has forecasted that 50% of sales will be in year 1, 35% in year 2 and 15% in year 3. What should be the amortisation charge in the second year of the product's life?**
   - **(a)** Rs.2,50,000
   - **(b)** Rs.1,75,000
   - **(c)** Rs.1,66,667
   - **(d)** Rs.1,85,000

Answer to the Multiple Choice Questions

1.	(c)	2.	(d)	3.	(a)	4.	(b)

Theoretical Questions

5. What is meant by Intangible Assets and what are the important factors to consider the recognition of item as an Intangible asset? What is the recognition criteria in accordance with the provisions of AS 26?

Answer:

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. Below are the 3 key ingredients to be satisfied to cover an item as an intangible asset under this standard:

- identifiability,
- control over a resource and
- expectation (i.e. probable – 50% plus) of future economic benefits flowing to the enterprise.

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; and

b. The cost of the asset can be measured reliably

6. What is the measurement criteria at the time of initial recognition of Intangible assets acquired through separate acquisition?

Answer:

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.

The cost of an intangible asset comprises:

- its purchase price,
- any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and
- any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services.
- Any trade discounts and rebates are deducted in arriving at the cost

7. What is the criteria for recognition and measurement of Internally generated intangible assets. Describe which kind of cost is considered for capitalisation with respect to provisions of AS 26. Whether the same applies for internally generated goodwill also?

Answer:

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into 2 phases:

- Research Phase &
- Development Phase

Research Phase - The expenses related to Research phase is expensed off in statement of Profit and loss.

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 of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the conditions given in para 6.15.

Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria. Reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports is prohibited.

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. For details, refer para 6.16.

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.

8. Advise the complete accounting treatment for Research and development phase as per AS 26.

Answer:

Research phase means acquisition of knowledge and Development phase means application of knowledge.

The expenditure related to Research phase is expensed off in statement of Profit and loss. However, the expenditure incurred in Development phase is capitalised as a cost of the internally generated intangible asset.

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

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9. What is meant by Amortisation of an Intangible asset. What are the different methods for amortisation as per AS 26?

Answer:

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. 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.

Scenario Based Questions

10. Swift Ltd. acquired a patent at a cost of Rs.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 Rs.10,00,000 per annum. The company had amortized the patent at 10,00,000 per annum in first two years on the basis of economic benefits derived from the product manufactured under the patent. After two years it was found that the product life-cycle may continue for another 5 years from then. The patent was renewable and Swift Ltd. got it renewed after expiry of five years. The net cash flows from the product during these 5 years were expected to be Rs.36,00,000, Rs.46,00,000, Rs.44,00,000, Rs.40,00,000 and Rs.34,00,000. Find out the amortization cost of the patent for each of the years.

Answer:

Swift Limited amortised Rs.10,00,000 per annum for the first two years i.e. Rs.20,00,000. The remaining carrying cost can be amortised 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:

S	Net cash flows Rs.	Amortisation Ratio	Amortisation Amount Rs.
I	-	0.125	10,00,000
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., Rs.60,00,000 has been amortised in the ratio of net cash flows arising from the product of Swift Ltd.

11. AB Ltd. launched a project for producing product X in October, 20X1. The Company incurred Rs.20 lakhs towards Research. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years.
Advise the Company as per the applicable Accounting Standard. (MTP May 24 S2 5M)

Answer:

As per para 41 of AS 26 "Intangible Assets", expenditure on research should be recognised as an expense when it is incurred. Hence, the expenses amounting Rs.20 lakhs incurred on the research has to be charged to the statement of profit and loss in the current year ending 31st March, 20X2.

12. During 20X1-X2, an enterprise incurred costs to develop and produce a routine low risk computer software product, as follows:

Particular	Rs.
Completion of detailed program and design (Phase 1)	50,000
Coding and Testing (Phase 2)	40,000
Other coding costs (Phase 3 & 4)	63,000
Testing costs (Phase 3 & 4)	18,000

Product masters for training materials (Phase 5)	19,500
Packing the products (1,500 units) (Phase 6)	16,500

After completion of phase 2, it was established that the product is technically feasible for the market. You are required to state how the above referred cost to be recognized in the books of accounts.

Answer:

As per 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 program design, coding and testing. In this case, Rs.90,000 would be recorded as an expense (Rs.50,000 for completion of detailed program design and Rs.40,000 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 (63,000+ 18,000+ 19,500) = Rs.1,00,500. Packing cost Rs.16,500 should be recognized as expenses and charged to P & L A/c.

13. As per provisions of AS-26, how would you deal to the following situations:

(1) Rs.23,00,000 paid by a manufacturing company to the legal advisor for defending the patent of a product is treated as a capital expenditure.

(2) During the year 20X1-X2, a company spent Rs.7,00,000 for publicity and research expenses on one of its new consumer product which was marketed in the same accounting year but proved to be a failure.

(3) A company spent Rs.25,00,000 in the past three years to develop a product, these expenses were charged to profit and loss account since they did not meet AS-26 criteria for capitalization. In the current year approval of the concerned authority has been received. The company wishes to capitalize Rs.25,00,000 by disclosing it as a prior period item.

(4) A company with a turnover of Rs.200 crores and an annual advertising budget of Rs.50,00,000 had taken up for the marketing of a new product by a company. It was estimated that the company would have a turnover of Rs.20 crore from the new product. The company had debited to its Profit & Loss Account the total expenditure of Rs.50,00,000 incurred on extensive special initial advertisement campaign for the new product. (MTP Jan 25 S1 5M)

Answer:

As per AS 26 "Intangible Assets", subsequent expenditure on an intangible asset after its purchase or its completion should be recognized 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) 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.

(i) In the given case, the legal expenses to defend the patent of a product amounting Rs.23,00,000 should not be capitalized and be charged to Profit and Loss Statement.

(ii) The company is required to expense the entire amount of Rs.7,00,000 in the Profit and Loss account for the year ended 31st March, 20X2 because no benefit will arise in the future.

(iii) As per AS 26, expenditure on an intangible item that was initially recognized as an expense by a reporting enterprise in previous annual financial statements should not be recognized as part of the

cost of an intangible asset at a later date. Thus the company cannot capitalize the amount of Rs.25,00,000 and it should be recognized as expense

(iv) Expenditure of Rs.50,00,000 on advertising and promotional activities should always be charged to Profit and Loss Statement. Hence, the company has done the correct treatment by debiting the sum of 50 lakhs to Profit and Loss Account.

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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: Sudesh Ltd. acquired a patent at a cost of Rs. 2,40,00,000 for a period of 5 years and the product life- cycle was also 5 years. The company capitalized the cost and started amortizing the asset at Rs. 48,00,000 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 Rs. 36,00,000, Rs. 46,00,000, Rs. 44,00,000, Rs. 40,00,000 and Rs. 34,00,000. Find out the amortization cost of the patent for each of the years if the patent was renewable and Sudesh Ltd. got it renewed after expiry of five years.
(MTP Mar'22 & Oct '23, PYP Sept 24)

Answer:

The entity amortized Rs. 48,00,000 per annum for the first two years i.e. Rs. 96,00,000. 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 amortization may be found as follows:

Year	Net cash flows Rs.	Amortization Ratio	Amortization Amount Rs.
I	-	0.20	48,00,000
II	-	0.20	48,00,000
III	36,00,000	0.180	25,92,000
IV	46,00,000	0.230	33,12,000
V	44,00,000	0.220	31,68,000
VI	40,00,000	0.200	28,80,000
VII	34,00,000	0.170	24,48,000
Total	2,00,00,000	1.000	2,40,00,000

It may be seen from above that from third year onwards, the balance of carrying amount i.e., Rs. 1,44,00,000 has been amortized in the ratio of net cash flows arising from the product of Change Ltd.

Question 2: During 2019-20 an enterprise incurred costs to develop and produce a routine low risk computer software product as follows:

Particular	Rs.
Completion of detailed program and design (Phase 1)	50,000
Coding and Testing (Phase 2)	40,000
Other coding costs (Phase 3 & 4)	63,000
Testing costs (Phase 3 & 4)	18,000
Product masters for training materials (Phase 5)	19,500
Packing the products (1,500 units) (Phase 6)	16,500

After completion of phase 2 it was established that the product is technically feasible for the market. You are required to state how the above referred cost to be recognized in the books of accounts.
(MTP April '23 RTP Jan 25)

Answer:

As per 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 program design or working model. In this case, Rs. 90,000 would be recorded as an expense (Rs. 50,000 for completion of detailed program design and Rs. 40,000 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 (63,000+ 18,000+ 19,500) = Rs. 1,00,500. Packing cost Rs. 16,500 should be recognized as expenses and charged to Profit & Loss A/c.

Question 3: PIL Ltd. is showing an intangible asset at Rs. 72 lakhs as on 31-3-2022. This asset was acquired for Rs. 120 lakhs as on 01-04-2016 and the same was used from that date. The company has been following the policy of amortization of the intangible assets over a period of 15 years, on straight line basis. You are required to comment on the accounting treatment of asset with reference to AS 26 "Intangible Assets" and also give the necessary rectification journal entry in the books. (MTP April 22)

Answer:

As per AS 26 'Intangible Assets', the depreciable amount of an intangible asset should be allocated on systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. The Company has been following the policy of amortization of the intangible asset over a period of 15 years on straight line basis. The period of 15 years is more than the maximum period of 10 years specified as per AS 26. Accordingly, the company would be required to restate the carrying amount of intangible asset as on 31.3.2022 at Rs. 48 lakhs i.e. Rs. 120 lakhs less Rs. 72 lakhs (Rs. 120 Lakhs / 10 years x 6 years = 72 Lakhs). The difference of Rs. 24 Lakhs (Rs. 72 lakhs – Rs. 48 lakhs) will be adjusted against the opening balance of revenue reserve. The carrying amount of Rs. 48 lakhs will be amortized over remaining 4 years by amortizing Rs. 12 lakhs per year.

The necessary journal entry (for rectification) will be Revenue Reserves Dr.	Rs. 24 Lakhs	
To Intangible Assets		Rs. 24 Lakhs

(Adjustment to reserves due to restatement of the carrying amount of intangible asset)

Question 4: X Ltd. carried on business of manufacturing of Bakery products. The company has two trademarks "Sun" and "Surya''. One month before the company knows through one of the marketing managers that both trademarks have allegedly been infringed by other competitors engaged in the same field. After investigation, legal department of the company informed that it had weak case on trademark "Sun" and strong case in regard to trademark "Surya". X Ltd. incurred additional legal fees to stop infringement on both trademarks. Both trademarks have a remaining legal life of 10 years. How should X Ltd. account for these legal costs incurred relating to the two trademarks? (MTP March '23)

Answer:

As per para 59 of AS 26, subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense. However, if the subsequent expenditure enables the asset to generate future economic benefits in excess of its originally assessed standard of performance or can be measured and attributed to the asset reliably, then such subsequent expenditure should be added to the cost of the intangible asset.

The legal costs incurred for both the trademarks do not enable them to generate future economic benefits in excess of its originally assessed standard of performance. They only ensure to maintain them if the case is decided in favour of the company. Therefore, such legal costs must be recognised as an expense.

Question 5: PQR Ltd. has acquired a Brand from another company for Rs. 100 lakhs. PQR

Ltd. contends that since the said brand is a very popular and famous brand, no amortization needs to be provided. Comment on this in line with the Accounting Standards. (May 22)

Answer:

AS 26 'Intangible Assets" provides that an intangible asset should be measured initially at cost. After Initial recognition, an intangible asset should be carried at cost less any accumulated amortization and any accumulated impairment losses. The amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life for computing amortization. There is a rebuttable presumption that the useful life of an intangible asset will not exceed 10 years from the date when the asset is available for use. It must be ensured that the value of brand is amortized in accordance with AS 26, as brand is considered to be intangible asset. The contention of PQR Ltd. that Brand is very popular and famous, hence no amortization needs to be provided is not correct as there is no persuasive evidence that the useful life of the intangible asset will exceed 10 years.

Question 6: M/s. Pasa Ltd. is developing a new production process. During the financial year ended 31st March, 2019, the total expenditure incurred on the process was ₹ 80 lakhs. The production process met the criteria for recognition as an intangible asset on 1st November, 2018. Expenditure incurred till this date was ₹ 42 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2020 was ₹ 90 lakhs. As on 31.03.2020, the recoverable amount of know how embodied in the process is estimated to be ₹ 82 lakhs. This includes estimates of future cash outflows and inflows.

You are required to work out :

(1) What is the expenditure to be charged to Profit and Loss Account for the year ended 31st March, 2019?

(2) What is the carrying amount of the intangible asset as on 31st March, 2019?

(3) What amount of expenditure to be charged to Profit and Loss Account for the year ended 31st March, 2020 ?

(4) What is the carrying amount of the intangible asset as on 31st March, 2020?

(MTP Sep'22 , Sep '23, MTP Jan 25 S2 7M)

Answer:

As per AS 26 'Intangible Assets'

(i) Expenditure to be charged to Profit and Loss account for the year ending 31.03.2019

₹ 42 lakhs is recognized as an expense because the recognition criteria were not met until 1st November, 2018. This expenditure will not form part of the cost of the production process recognized as an intangible asset in the balance sheet.

(ii) Carrying value of intangible asset as on 31.03.2019

At the end of financial year, on 31st March 2019, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 38 (80-42) lakhs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st November 2018)

(iii) Expenditure to be charged to Profit and Loss account for the year ended 31.03.2020

	(₹ in lacs)
Carrying Amount as on 31.03.2019	38
Expenditure during 2019 – 2020	90
Book Value	128
Recoverable Amount	(82)

Impairment loss to be charged to Profit and loss account	46

₹ 46 lakhs to be charged to Profit and loss account for the year ending 31.03.2020.

(iv) Carrying value of intangible asset as on 31.03.2020

	(₹ in lacs)
Book Value	128
Less: Impairment loss	(46)
Carrying amount as on 31.03.2020	82

Question 7: Swift Limited acquired patent rights to manufacture Solar Roof Top Panels at a cost of ₹ 600 lacs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of future cash flows which are estimated as under:

Year	1	2	3	4	5
Cash Flows (₹ in lacs)	300	300	300	150	150

After 3rd year, it was estimated that the patents would have an estimated balance future life of 3 years and Swift Ltd. expected the estimated cash flow after 5th year to be ₹ 75 Lacs. Determine the amortization cost of the patent for each of the above years as per Accounting Standard 26.(RTP Nov '23)

Answer:

Amortization of cost of patent as per AS 26

Year	Estimated future cash flow (₹ in lakhs)	Amortization Ratio	Amortized Amount (₹ in lakhs)
1	300	.25	150
2	300	.25	150
3	300	.25	150
4	150	.10	60
5	150	.10	60
6	75	.05	30
		1.00	600

In the first three years, the patent cost will be amortized in the ratio of estimated future cash flows i.e. (300: 300: 300: 150: 150).The unamortized amount of the patent after third year will be ₹ 150 lakh (600- 450) which will be amortized in the ratio of revised estimated future cash flows (150:150:75 or 2:2:1) in the fourth, fifth and sixth year.

AS – 28: Impairment of Assets

Illustrations

Illustration 1

Ergo Industries Ltd. gives the following estimates of cash flows relating to Property, Plant and Equipment on 31-12-20X1. The discount rate is 15%.

Year	Cash Flow (Rs.in lakhs)
20X2	4000
20X3	6000
20X4	6000
20X5	8000
20X6	4000

Residual value at the end of 20X6 = Rs.1000 lakhs

Property, Plant and Equipment purchased on 1-1-20XX = Rs.40,000 lakhs

Useful life = 8 years

Net selling price on 31-12-20X1 = Rs.20,000 lakhs

Calculate on 31-12-20X1:

(a) Carrying amount at the end of 20X1

(b) Value in use on 31-12-20X1

(c) Recoverable amount on 31-12-20X1

(d) Impairment loss to be recognized for the year ended 31-12-20X1

(e) Revised carrying amount

(f) Depreciation charge for 20X2.

Note: The year 20XX is the immediate preceding year before the year 20X0.

Solution:

Calculation of value in use

Year	Cash Flow	Discount as per 15%	Discounted cash flow
20X2	4,000	0.870	3,480
20X3	6,000	0.756	4,536
20X4	6,000	0.658	3,948
20X5	8,000	0.572	4,576
20X6	4,000	0.497	1,988
20X6	(residual) 1,000	0.497	497
			19,025

(a) Calculation of carrying amount:

Original cost = Rs.40,000 lakhs

Depreciation for 3 years = [(40,000-1000) x 3/8] = Rs.14,625 lakhs

Carrying amount on 31-12-20X1 = [40,000-14,625] = Rs.25,375 lakhs

(b) Value in use = Rs.**19,025 lakhs**

(c) Recoverable amount = higher of value in use and net selling price i.e. Rs.20,000 lakhs.

Recoverable amount = Rs.20,000 lakhs

(d) Impairment Loss = Rs.(25,375-20,000) = Rs.5,375 lakhs

(e) Revised carrying amount = Rs.(25,375-5,375) = Rs.20,000 lakhs

(f) Depreciation charge for 20X2 = (20,000-1000)/5 = Rs.3,800 lakhs

Illustration 2

X Ltd. is having a plant (asset) carrying amount of which is Rs.100 lakhs on 31.3.20X1. Its balance useful life is 5 years and residual value at the end of 5 years is Rs.5 lakhs. Estimated future cash flow from using the plant in next 5 years are:

For the year ended on	Estimated cash flow (Rs.in lakhs)
31.3.20X2	50
31.3.20X3	30
31.3.20X4	30
31.3.20X5	20
31.3.20X6	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 31.3.20X1 is Rs.60 lakhs.

Solution:

Present value of future cash flow

Year ended	Future Cash Flow	Discount @ 10% Rate	Discounted cash flow
31.3.20X2	50	0.909	45.45
31.3.20X3	30	0.826	24.78
31.3.20X4	30	0.751	22.53
31.3.20X5	20	0.683	13.66
31.3.20X6	20	0.620	12.40
			118.82
Present value of residual price on 31.3.20X6 = 5 x 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 31.3.20X1 is Rs.60 lakhs, the recoverable amount will be higher of Rs.121.92 lakhs (value in use) and Rs.60 lakhs (net selling price), hence recoverable amount is Rs.121.92 lakhs.

Illustration 3

G Ltd., acquired a machine on 1st April, 20X0 for Rs.7 crore that had an estimated useful life of 7 years. The machine is depreciated on straight line basis and does not carry any residual value. On 1st April, 20X4, the carrying value of the machine was reassessed at Rs.5.10 crore and the surplus arising out of the revaluation being credited to revaluation reserve. For the year ended March, 20X6, conditions indicating an impairment of the machine existed and the amount recoverable ascertained to be only Rs.79 lakhs. You are required to calculate the loss on impairment of the machine and show how this loss is to be treated in the books of G Ltd. G Ltd., had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.

Solution:

Statement Showing Impairment Loss

(Rs.in crores)

Carrying amount of the machine as on 1st April, 20X0	7.00
Depreciation for 4 years i.e. 20X0-20X1 to 20X3-20X4 $\left[\frac{7 \text{ crores}}{7 \text{ years}} \times 4 \text{ years}\right]$	(4.00)

Carrying amount as on 31.03.20X4	3.00
Add: Upward Revaluation (credited to Revaluation Reserve account)	2.10
Carrying amount of the machine as on 1st April, 20X4 (revalued)	5.10
Less: Depreciation for 2 years i.e. 20X4-20X5& 20X5-20X6 $\left[\frac{5.1 \text{ crores}}{3 \text{ years}} \times 2 \text{ years}\right]$	(3.40)
Carrying amount as on 31.03.20X6	1.70
Less: Recoverable amount	(0.79)
Impairment loss	0.91
Less: Balance in revaluation reserve as on 31.03.20X6:	
Balance in revaluation reserve as on 31.03.20X4	2.10
Less: Enhanced depreciation met from revaluation reserve	
20X4-20X5 & 20X5-20X6=[(1.70 – 1.00) x 2 years] (1.40)	
Impairment loss set off against revaluation reserve balance as per para 58 of AS 28 "Impairment of Assets"	(0.70)
Impairment Loss to be debited to profit and loss account	0.21

Illustration 4

X Ltd. purchased a Property, Plant and Equipment four years ago for Rs.150 lakhs and depreciates it at 10% p.a. on straight line method. At the end of the fourth year, it has revalued the asset at Rs.75 lakhs and has written off the loss on revaluation to the profit and loss account. However, on the date of revaluation, the market price is Rs.67.50 lakhs and expected disposal costs are Rs.3 lakhs. What will be the treatment in respect of impairment loss on the basis that fair value for revaluation purpose is determined by market value and the value in use is estimated at Rs.60 lakhs?

Solution:

Treatment of Impairment Loss

As per para 57 of AS 28 "Impairment of assets", if the recoverable amount (higher of net selling price and its value in use) of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. In the given case, net selling price is Rs.64.50 lakhs (Rs.67.50 lakhs – Rs.3 lakhs) and value in use is Rs.60 lakhs. Therefore, recoverable amount will be Rs.64.50 lakhs. Impairment loss will be calculated as Rs.10.50 lakhs [Rs.75 lakhs (Carrying Amount after revaluation - Refer Working Note) less Rs.64.50 lakhs (Recoverable Amount)].

Thus impairment loss of Rs.10.50 lakhs should be recognised as an expense in the Statement of Profit and Loss immediately since there was downward revaluation of asset which was already charged to Statement of Profit and Loss.

Working Note:

Calculation of carrying amount of the Property, Plant and Equipment at the end of the fourth year on revaluation

(Rs.in lakhs)

Purchase price of a Property, Plant and Equipment	150.00
Less: Depreciation for four years [(150 lakhs / 10 years) x 4 years]	(60.00)
Carrying value at the end of fourth year	90.00
Less: Downward revaluation charged to profit and loss account	(15.00)
Revalued carrying amount	75.00

Test Your Knowledge

1. **If there is indication that an asset may be impaired but the recoverable amount of the asset is more than the carrying amount of the asset, the following are true:**
   - **(a)** No further action is required and the company can continue the asset in the books at the book value itself.
   - **(b)** The entity should review the remaining useful life, scrap value and method of depreciation and amortization for the purposes of AS 10.
   - **(c)** The entity can follow either (a) or (b).
   - **(d)** The entity should review the scrap value and method of depreciation and amortization for the purposes of AS 10.

2. **In case Goodwill appears in the Balance Sheet of an entity, the following is true:**
   - **(a)** Apply Bottom-up test if goodwill cannot be allocated to CGU (cash generating unit) under review.
   - **(b)** Apply Top-down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
   - **(c)** Apply both Bottom-up test and Top-down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
   - **(d)** Apply either Bottom-up test or Top-down test if goodwill cannot be allocated to CGU (cash generating unit) under review.

3. **In case of Corporate assets in the Balance Sheet of an entity, the following is true:**
   - **(a)** Apply Bottom up test if corporate assets cannot be allocated to CGU (cash generating unit) under review.
   - **(b)** Apply Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.
   - **(c)** Apply both Bottom up test and Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.
   - **(d)** Apply either Bottom up test or Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.

4. **In case of reversal of impairment loss, which statement is true:**
   - **(a)** Goodwill written off can never be reversed.
   - **(b)** Goodwill written off can be reversed without any conditions to be met.
   - **(c)** Goodwill written off can be reversed only if certain conditions are met.
   - **(d)** Goodwill written off can be reversed.

Answer to the Multiple Choice Questions

1.	(b)	2.	(c)	3.	(c)	4.	(c)

Theoretical Questions

5. Write short note on impairment of asset and its application to inventory.

Answer:

The objective of AS 28 'Impairment of Assets' is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognize an impairment loss.

- If carrying amount < = Recoverable amount : Asset is not impaired
- If carrying amount > Recoverable amount : Asset is impaired

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use This standard should be applied in accounting for the impairment of all assets, other than (i) inventories (AS 2, Valuation of Inventories); (ii) assets arising from construction contracts (AS 7, Accounting for Construction Contracts); (iii) financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and (iv) deferred tax assets (AS 22, Accounting for Taxes on Income). AS 28 does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because other accounting standards applicable to these assets already contain specific requirements for recognizing and measuring the impairment related to these assets.

Scenario Based Questions

6. A publisher owns 150 magazine titles of which 70 were purchased and 80 were self created. The price paid for a purchased magazine title is recognized as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognized as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title.
Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment. What is the cash
generating unit for an individual magazine title?

Answer:

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title.

In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent of each other and that each magazine title is a separate cash-generating unit

7. An asset does not meet the requirements of environment laws which have been recently enacted. The asset has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at Rs.6,00,000. The estimated cost of destroying the asset is Rs.70,000. How is the asset to be accounted for?

Answer:

As per AS 28 "Impairment of Assets", impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, where recoverable amount is the higher of an asset's net selling price and its value in use. In the given case, recoverable amount will be nil [higher of value in use (nil) and net selling price (negative Rs.70,000)]. Thus impairment loss will be calculated as Rs.6,00,000 [carrying amount (Rs.6,00,000) – recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss of Rs.6,00,000 has to be recognized as an expense immediately in the statement of Profit and Loss as per para 58 of AS 28.

Further, as per para 60 of AS 28, When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an enterprise should recognise a liability if, and only if, that is required by another Accounting Standard. Hence, the entity should recognize liability for cost of disposal of Rs.70,000 as per AS 10 & 29.

8. Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 20X1 for Rs.60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 20X1-20X2 the carrying amount was Rs.41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch Rs.36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of Rs.54 crore per annum and has a carrying amount of Rs.3.46 crore. All such machines put together could fetch a sum of Rs.4.44 crore if disposed. Discuss the applicability of Impairment loss.

Answer:

As per provisions of AS 28 "Impairment of Assets", impairment loss is not to be recognized for a given asset if its cash generating unit (CGU) is not impaired. In the given question, the related cash generating unit which is group of asset to which the damaged machine belongs is not impaired; and the recoverable amount is more than the carrying amount of group of assets. Hence there is no need to provide for impairment loss on the damaged sachet filling machine.

9. From the following details of an asset

i. Find out impairment loss

ii. Treatment of impairment loss

iii. Current year depreciation

Particulars of asset:

Cost of asset	**Rs.56 lakhs**
Useful life period	**10 years**
Salvage value	**Nil**
Current carrying value	**Rs.27.30 lakhs**
Useful life remaining	**3 years**
Recoverable amount	**Rs.12 lakhs**
Upward revaluation done in last year	**Rs.14 lakhs**

Answer:

According to AS 28 "Impairment of Assets", an impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is

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.

Impairment Loss and its treatment	**Rs.**
Current carrying amount (including revaluation amount of Rs.14 lakhs)	27,30,000
Less: Current recoverable amount	(12,00,000)
Impairment Loss	15,30,000
Impairment loss charged to revaluation reserve	14,00,000
Impairment loss charged to profit and loss account	1,30,000

After the recognition of an impairment loss, the depreciation (amortization) 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.

In the given case, the carrying amount of the asset will be reduced to Rs.12,00,000 after impairment. This amount is required to be depreciated over remaining useful life of 3 years (including current year). Therefore, the depreciation for the current year will be Rs.4,00,000.

10. A plant was acquired 15 years ago at a cost of Rs.5 crores. Its accumulated depreciation as at 31st March, 20X1 was Rs.4.15 crores. Depreciation estimated for the financial year 20X1-20X2 is Rs.25 lakhs. Estimated Net Selling Price as on 31st March, 20X1 was Rs.30 lakhs, which is expected to decline by 20 per cent by the end of the next financial year. Its value in use has been computed at Rs.35 lakhs as on 1st April, 20X1, which is expected to decrease by 30 per cent by the end of the financial year.

(i) Assuming that other conditions for applicability of the impairment Accounting Standard are satisfied, what should be the carrying amount of this plant as at 31st March, 20X2?

(ii) How much will be the amount of write off for the financial year ended 31st March, 20X2?

(iii) If the plant had been revalued ten years ago and the current revaluation reserves against this plant were to be Rs.12 lakhs, how would you answer to questions (i) and (ii) above?

(iv) If the value in use was zero and the enterprise were required to incur a cost of Rs.2 lakhs to dispose of the plant, what would be your response to questions (i) and (ii) above?

Answer:

As per AS 28 "Impairment of Assets", if the recoverable amount* of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount and that reduction is an impairment loss.

An impairment loss on a revalued asset is recognized as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is 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.

In the given case, recoverable amount (higher of asset's net selling price and value in use) will be Rs.24.5 lakhs on 31.3.20X2 according to the provisions of AS 28 [Refer working note].

(Rs.in lakhs)

(i)	Carrying amount of plant (after impairment) as on 31st March, 20X2	24.50
(ii)	Amount of write off (impairment loss) for the financial year ended 31st March, 20X2 [Rs.60 lakhs – Rs.24.5 lakhs]	35.50
(iii)	If the plant had been revalued ten years ago	
	Debit to revaluation reserve	12.00

	Amount charged to profit and loss account	
	(Rs.35.50 lakhs – Rs.12 lakhs)	23.50
(iv)	If Value in use is zero	
	Value in use (a)	Nil
	Net selling price (b) (-)	2.00
	Recoverable amount [higher of (a) and (b)]	Nil
	Carrying amount (closing book value)	Nil
	Amount of write off (impairment loss) (Rs.60 lakhs – Nil)	60.00
	Entire book value of plant will be written off and charged to profit and loss account.	

Working Note:

Calculation of Closing Book Value, Estimated Net Selling Value and Estimated Value in Use of Plant at 31st March, 20X2

	(Rs.in lakhs)
Opening book value as on 1.4.20X1 (Rs.500 lakhs – Rs.415 lakhs)	85
Less: Depreciation for financial year 20X1-20X2	(25)
Closing book value as on 31.3.20X2	60
Estimated net selling price as on 1.4.20X1	30
Less: Estimated decrease during the year (20% of Rs.30 lakhs)	(6)
Estimated net selling price as on 31.3.20X2	24
Estimated value in use as on 1.4.20X1	35.0
Less: Estimated decrease during the year (30% of Rs.35 lakhs)	(10.5)
Estimated value in use as on 31.3.20X2	24.5

SHRESHTA
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Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: A machine was acquired by Zest Ltd. on 01/04/2019 for ₹ 60 lakhs. It had a useful life of 6 years. The machine is depreciated on straight line basis and does not carry any residual value. On 01/04/2022, the carrying value of the machine was reassessed at ₹ 36 lakhs. The surplus arising out of the revaluation being credited to revaluation reserve.

For the year ended March 2024, conditions indicating an impairment of the existed machine and the amount recoverable ascertained to be ₹ 9 lakhs.

You are required to calculate the loss on impairment of the machine and show how this loss is to be treated in the books of Zest Ltd. The company had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.

(PYP May 25 4 Marks)

Answer:

Statement Showing Impairment Loss

	(₹ in lakhs)
Carrying amount of the machine as on 1st April, 2019	60
Depreciation for 3 years i.e. 2019-2020 to 2021-2022 [60 Lakh / 6 years x 3 years]	(30)
Carrying amount as on 31.03.2022	30
Add: Upward Revaluation (credited to Revaluation Reserve account)	6
Carrying amount of the machine as on 1st April, 2022 (revalued)	36
Less: Depreciation for 2 years i.e. 2022-2023 & 2023-2024 [36 Lakh /3 years x 2 years]	(24)
Carrying amount as on 31.03.2024	12
Less: Recoverable amount	(9)
Impairment loss	3
Less: Balance in revaluation reserve as on 31.03.2024:	6
Less: Enhanced depreciation met from revaluation reserve	
2022-2023 & 2023-2024 = [(12 – 10) x 2 years]	(4)
Impairment loss set off against revaluation reserve balance as per para 58 of AS 28 "Impairment of Assets"	(2)
Impairment Loss to be debited to profit and loss account	1

Question 2:

Grace Limited acquired business (cash-generating units) of Venus Limited on 31st March 2023 for ₹ 8,000 Lakhs. The details of acquisition are as under:

Fair value of identifiable asset : ₹ 6,000 Lakhs

Goodwill (to be amortized in 5 years) : ₹ 2,000 Lakhs

The anticipated useful life of acquired assets is 8 years with no residual value. Grace Limited uses straight-line method of depreciation. On 31st March 2025, Grace Limited estimated significant decline in production due to change in Government policies, the net selling price of identifiable asset is ₹ 3,000 lakhs. Grace Limited closes its books on 31st March of each year. The cash flow forecast based on recent financial budget for next 6 years are:

Year	Estimated cash flow (₹ in Lakhs)
2025-2026	1,000
2026-2027	800

2027-2028	700
2028-2029	800
2029-2030	600
2030-2031	500

You are required to calculate:

(i) Value in use if discounting rate is 10% on 31 March 2025.

(ii) Impairment loss to be recognized for the year ended 31 March 2025.

(iii) Revised carrying amount of asset on 31 March 2025.

(P.V. factor @ 10% 0.909, 0.826, 0.751, 0.683, 0.621, 0.564) (PYP Sep 25 7M)

Answer:

(i) Calculation of Value in Use (VIU) as at 31-03-2025

Year	Cash flow (₹ in lakhs)	PV factor @10%	PV (₹ in lakhs)
2025-26	1,000	0.909	909.00
2026-27	800	0.826	660.80
2027-28	700	0.751	525.70
2028-29	800	0.683	546.40
2029-30	600	0.621	372.60
2030-31	500	0.564	282.00
Total VIU			3,296.50

Value in Use (rounded) = ₹ 3,297 lakhs

(ii) Impairment loss to be recognised for the year ended 31st March, 2025

Impairment loss required = Carrying amount – Recoverable amount = ₹ 5,700 – ₹ 3,297 = 2,403 lakhs.

(iii) Revised carrying amount of identifiable asset

= ₹ 4,500 – ₹1,203

= ₹ 3,297 lakhs

Calculation of Impairment Loss and revised carrying amount

	Goodwill	Identifiable Assets	CGU Total
Acquisition cost on 31st March'2023	2,000	6,000	5,700
Less: Amortization- (Cost/5)*2 / Depreciation (Cost/8)*2 for 2 years	800	1500	3,297
	1,200	4,500	2,403
Recoverable Amount (See Note below)	1,200	1,203	
Impairment Loss to be recognised Allocation of impairment loss (See Note)	0	3,297	
Carrying amount after impairment			

Note:

1. Recoverable amount and impairment test
   - Fair value less costs to sell for the identifiable asset given = ₹ 3,000 lakhs. (Note: fair value less costs to sell of whole CGU not provided; value in use of CGU computed above.)
   - Recoverable amount of the CGU = higher of Value in Use (3,297) and Fair value less costs to sell (use value for comparison). → Recoverable amount = ₹ 3,297 lakhs (since 3,297 > 3,000).
   - Carrying amount (pre-impairment) = 5,700 lakhs.
   - Impairment loss required = Carrying amount – Recoverable amount = 5,700 – 3,297 = 2,403 lakhs.

2. Allocation of impairment loss

   As per AS 28 impairment loss for a cash-generating unit is allocated first to reduce goodwill carrying amount to zero, and then to other assets of the unit pro-rata (or as required) so that carrying amount after allocation equals recoverable amount.

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AS - 29 (Revised) Provisions, Contingent Liabilities and Contingent Assets

Illustrations

Illustration 1

At the end of the financial year ending on 31st December, 20X1, 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 (Rs.)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Lose (Low damages)	40%	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 (Revised) '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 not 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 50% and for remaining five cases is 50%. As per AS 29 (Revised), 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 remote, 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 = 40% of Rs.1,20,000 + 10% of Rs.2,00,000
= Rs.48,000 + Rs.20,000 = Rs.68,000

Expected loss in remaining five cases = 30% of Rs.1,00,000 + 20% of Rs.2,10,000
= Rs.30,000 + Rs.42,000 = Rs.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 Rs.10,40,000 (Rs.68,000 x 10 + Rs.72,000 x 5) as contingent liability.

Illustration 2

EXOX Ltd. is in the process of finalising its accounts for the year ended 31st March, 20X2. The company seeks your advice on the following:

(i) The Company's sales tax assessment for assessment year 20X1-X2 has been completed on 14th February, 20X4 with a demand of Rs.2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

(ii) The Company has entered into a wage agreement in May, 20X2 whereby the labour union has accepted a revision in wage from June, 20X1. The agreement provided that the hike till May, 20X2 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 20X2.

Solution:

(i) Since the company is not appealing against the addition of Rs.0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 20X4. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed as a contingent liability of Rs.2.10 crore.

(ii) The arrears for the period from June, 20X1 to March, 20X2 are required to be provided for in the accounts of the company for the year ended on 31st March, 20X2.

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Test Your Knowledge

1. **Which of the following best describes a provision?**
   - **(a)** A provision is a liability of uncertain timing or amount.
   - **(b)** A provision is a possible obligation of uncertain timing.
   - **(c)** A provision is a credit balance set up to offset a contingent asset so that the effect on the statement of financial position is nil.
   - **(d)** A provision is a possible obligation of uncertain amount.

2. **X Co is a business that sells second hand cars. If a car develops a fault within 30 days of the sale, X Co will repair it free of charge. At 1st March 20X1, X Co had made a provision for repairs of Rs.25,000. At 31st March 20X1, X Co calculated that the provision should be Rs.20,000. What entry should be made for the provision in X Co's income statement for the month 31st March 20X1?**
   - **(a)** A charge of Rs.5,000
   - **(b)** A credit of Rs.5,000
   - **(c)** A charge of Rs.20,000
   - **(d)** A credit of Rs.25,000

3. **Which of the following item does the statement below describe?**
   "A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control"
   - **(a)** A provision
   - **(b)** A current liability
   - **(c)** A contingent liability
   - **(d)** Deferred tax liability

4. **Z Ltd has commenced a legal action against Y Ltd claiming substantial damages for supply of a faulty product. The lawyers of Y Ltd have advised that the company is likely to lose the case, although the chances of paying the claim is not remote. The estimated potential liability estimated by the lawyers are:**
   Legal cost (to be incurred irrespective of the outcome of the case) Rs.50,000
   Settlement if the claim is required to be paid Rs.5,00,000
   What is the appropriate accounting treatment in the books of Z Ltd.?
   - **(a)** Create a Provision of Rs.5,50,000
   - **(b)** Make a Disclosure of a contingent liability of Rs.5,50,000
   - **(c)** Create a Provision of Rs.50,000 and make a disclosure of contingent liability of Rs.5,00,000
   - **(d)** Create a Provision of Rs.5,00,000

Answer to the Multiple Choice Questions

1.	(a)	2.	(b)	3.	(c)	4.	(c)

Theoretical Questions

5. When should provision be recognized as per provisions of AS 29? Explain in brief.

Answer:

A provision should be recognised only 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

Scenario Based Questions

6. Sun Ltd. has entered into a sale contract of Rs.5 crores with X Ltd. during 20X1-20X2 financial year. The profit on this transaction is Rs.1 crore. The delivery of goods to take place during the first month of 20X2-20X3 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of Rs.1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 20X1-20X2 financial year. As on balance sheet date (31.3.20X2), the goods were not manufactured, and it was unlikely that Sun Ltd. will be able to meet the contractual obligation.

(i) Should Sun Ltd. provide for contingency as per AS 29?

(ii) Should provision be measured as the excess of compensation to be paid over the profit?

Answer:

(i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognized. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting Rs.1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 20X2 and no profit had accrued for the financial year 20X1-20X2. Therefore, provision should be made for the full amount of compensation amounting Rs.1.50 crores.

7. An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31st March 20X1, it is virtually certain that a law requiring a clean up of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary?

Answer:

As per para 29 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a past event will lead to present obligation when the enterprise has no realistic alternative to settle the obligation created by the past event.

However, when environmental damage is caused, there may be no obligation to remedy the consequences. 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.

In the given case it is virtually certain that law will be enacted requiring clean-up of a land already contaminated. Therefore, an oil company has to provide for such clean-up cost in the year in which the law is virtually certain to be enacted

8. A Ltd. provides after sales warranty for two years to its customers. Based on past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period.

Less than 1 year: 2% provision

More than 1 year: 3% provision

The company has raised invoices as under :

Invoice Date	**Amount (Rs.)**
11th Feb, 20X0	**60,000**
25th Dec, 20X0	**40,000**
04th Oct, 20X1	**1,35,000**

Calculate the provision to be made for warranty under AS-29 as at 31st March, 20X1 and 31st March, 20X2. Also compute amount to be debited to P & L account for the year ended 31st March, 20X2. (MTP Jan 25 S1 4M)

Answer:

Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

As at 31st March, 20X1 = Rs.60,000 x .02 + Rs.40,000 x .03
= Rs.1,200 + Rs.1,200 = Rs.2,400

As at 31st March, 20X2 = Rs.40,000 x .02 + Rs.1,35,000 x .03
= Rs.800 + Rs.4,050 = Rs.4,850

Amount debited to Profit and Loss Account for year ended 31st March, 20X2

	Rs.
Balance of provision required as on 31.03.20X2	4,850
Less: Opening Balance as on 1.4.20X1	(2,400)
Amount debited to profit and loss account	2,450

Note: No provision will be made on 31st March, 20X2 in respect of sales amounting Rs.60,000 made on 11th February, 20X0 as the warranty period of 2 years has already expired.

Questions from MRP [MTPs, RTPs, Past Exam Papers]

Question 1: An airline is required by law to overhaul its aircraft once in every five years. The pacific Airlines which operate aircrafts does not provide any provision as required by law in its final accounts. You are required to comment on the validity of the treatment done by the company in line with the provisions of AS 29. (MTP April '23)

Answer:

A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29. The cost of overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts. Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts. Further, the enterprise can avoid the future expenditure by its future action, for example by selling the aircraft. However, an obligation might arise to pay fines or penalties under the legislation after completion of five years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than five years.

Question 2:

(i) XYZ Ltd. is in a dispute with a competitor company. The dispute is regarding alleged infringement of Copyrights. The competitor has filed a suit in the court of law seeking damages of Rs. 200 lacs.

The Directors are of the view that the claim can be successfully resisted by the Company. How would the matter be dealt in the annual accounts of the Company in the light of AS 29? Explain in brief giving reasons for your answer.(RTP Nov 18, May 19)

(ii) What is meant by "Restructuring Provision" as per AS 29? What costs are excluded while computing such provision as per the standard? (MTP April 22)

Answer:

(i) As per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision should be recognized when

- an enterprise has a present obligation as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognized.

In the given situation, since, the directors of the company are of the opinion that the claim can be successfully resisted by the company, therefore there will be no outflow of the resources. Hence, no provision is required. The company will disclose the same as contingent liability by way of the following note:

"Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed copyrights and is seeking damages of Rs. 200 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company."

(ii) As per AS 29, 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.

Question 3:

Saharsh Ltd. is engaged in manufacturing of electric home appliances. The company is in the process of finalizing its accounts for the year ended 31.3.2023 and needs your expert advice on the following issues:

(i) The company has its plants at 3 different locations. It has to shut down one of its plants due to internal reasons. The said plant site is under a rental agreement till 31.3.2024. The rent per month is Rs. 80,000. If the company cancels the agreement, it has to pay a penal amount equal to six month's rent. The company also has an option to sub-let the site at a rent of Rs. 45,000 per month.

(ii) A case has been filed against the company in the consumer court and a notice for levy of a penalty of Rs. 20 lakhs has been received. The company has appointed a lawyer to defend the case for a fee of Rs. 2 lakhs. 50% of the fees has been paid and balance 50% will be paid after finalisation of the case. There are 75% chances that the penalty may not be levied.

(iii) The company had committed to supply a consignment worth Rs. 1 crore to one of its dealers by the year-end. As per the contract, if delivery is not made on time, a compensation of 15% of the value is to be paid. While the consignment was in transit, one of the trucks carrying goods worth Rs. 30 lakhs met with an accident. It was however covered by Insurance. According to the surveyor's report, the policy amount is collectable, subject to 10% deduction. Before closing the books of accounts, the company has received the information that the policy amount has been processed and the dealer has also claimed for the compensation.

Give your answers based on relevant Accounting standard.

(MTP March '23 & Oct '23, RTP May '25)

Answer:

(i) As per AS 29, an 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract is the lower of net cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

In the given case, Saharsh Ltd. is required to pay:

In case of cancellation of agreement:

= Rs. 80,000 x 6 months = Rs. 4,80,000

In case of continuance of agreement (in case of sub-let):

Net of rent paid over rent collected from sub-tenant (Rs. 80,000 -45,000) x 12 = Rs. 4,20,000.

Lower of the above is to be provided for i.e. Rs. 4,20,000 is to be provided for.

(ii) As per AS 29, 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.

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.

In the given case, there are 75% chances that the penalty may not be levied. Accordingly, Saharsh Ltd. should not make the provision for penalty.

However, a provision should be made for remaining 50% fees of the lawyer in the financial

statements of financial year 2023-2024.

(iii)

Loss due to accident	Rs. 30,00,000
Insurance claim receivable by company = Rs. 30,00,000 x 90% =	Rs. 27,00,000
Loss to be recognised in the books for 2023-2024	Rs. 3,00,000
Insurance claim receivable to be recorded in the books	Rs. 27,00,000
Compensation claim by dealer against company to be provided for in the books = Rs. 30,00,000 x 15%=	Rs. 4,50,000*

***Note:** Alternatively, the compensation @ 15% can be computed on the whole contract amount of Rs. 1 crore. In such a situation, the compensation should be Rs. 15,00,000 (1 crore x 15%).

Question 4: XYZ Ltd. has not made provision for warrantee in respect of certain goods due to the fact that the company can claim the warranty cost from the original supplier. Hence the accountant of the company says that the company is not having any liability for warrantees on a particular date as the amount gets reimbursed. You are required to comment on the accounting treatment done by the XYZ Ltd. in line with the provisions of AS 29. (MTP Mar'22 & Sep '22)

Answer:

As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision. It is apparent from the Question that the company had not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. However, the provision for warranty should have been made as per AS 29 and the amount claimable as reimbursement should be treated as a separate asset in the financial statements of the company rather than omitting the disclosure of such liability. Accordingly, it is viewed that the accounting treatment adopted by the company with respect to warranty is not correct.

Question 5: A Company dealing in software provides after sales warranty for 2 years to its customer. Based on past experience, the company has been following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period:

Less than 1 year: 3% provision

More than 1 year: 4% provision

The company has raised invoices as under:

Invoice Date	Amount (₹)
19th January, 2019	1,20,000
29th January, 2020	75,000
15th October, 2020	2,70,000

You are required to calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2020 and 31st March, 2021. Also compute the amount to be debited to Profit and Loss Account for the year ended 31st March, 2021.

(MTP Oct'22, RTP May '23, PEP Jan 25)

Answer:

Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

As at 31st March, 2020 = ₹ 1,20,000 x .03 + ₹ 75,000 x .04

= ₹ 3,600 + ₹ 3,000 = ₹ 6,600

As at 31st March, 2021 = ₹ 75,000 x .03 + ₹ 2,70,000 x .04

= ₹ 2,250 + ₹ 10,800 = ₹ 13,050

Amount debited to Profit and Loss Account for year ended 31st March, 2021

	₹
Balance of provision required as on 31.03.2021	13,050
Less: Opening Balance as on 1.4.2020	(6,600)
Amount debited to profit and loss account	6,450

Note: No provision will be made on 31st March, 2021 in respect of sales amounting ₹ 1,20,000 made on 19th January, 2019 as the warranty period of 2 years has already expired.

Question 6: Chaos Limited is in the process of finalizing its accounts for the year ended 31st March, 2020. It seeks your advice in the following cases:

(i) Chaos Limited has filed a court case in 2014-2015 against its competitors. It became evident to its lawyers during the year ended 31st March, 2020 that Chaos Limited may lose the case and would have to pay Rs. 3,00,000 being the cost of litigation. No entries/provisions have been made in the books.

(ii) A new regulation has been passed in 2019-2020 by the healthcare ministry to upgrade facilities. Deadline set by the government is 31.03.2021. The company estimates an expenditure of Rs. 10,00,000 for the said upgrade.

(iii) The company gives one year warranty for its healthcare equipment under the contract of sale that it will make good any manufacturing defect by repair or replacement. As per past experience, it is probable that there will be 1% such cases and estimated cost of repair / replacement is estimated at 10% of such sale value. During the year, the company has made a sale of Rs. 5 crores.

Kindly give your Answer for each of above with proper reasoning according to the relevant Accounting Standard. Also state the principles for recognition of provision, as per AS 29.

(RTP May'22)

Answer:

Principles for recognition of provisions: As per AS 29, "a provision shall be recognised when:

(i) an entity has a present obligation (legal or constructive) as a result of a past event;

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

(iii) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised."

Accounting treatment under the given scenarios:

(i) On 31st March, 2020, since it is evident to the lawyer that Chaos Limited may lose the case and also a reliable estimate of the outflow can be made as Rs. 3,00,000, there is a present obligation. Hence, provision should be recognised for Rs. 3,00,000 for the amount which may be required to settle the obligation.

(ii) Under new regulation, an entity is required to upgrade its facilities by 31 st March, 2021. However, on 31st March, 2020, i.e. at the end of the reporting period, there is no obligation because there is no obligating event either for the costs of upgrading the facilities or for fines under the regulations. Hence, no provision should be recognized on 31st March, 2020 for upgrading the facilities by 31st March, 2021.

(iii) The obligating event is the sale of health care equipment with a warranty, which gives rise to a legal obligation. Here, an outflow of resources embodying economic benefits in settlement is probable for the warranties as a whole. Hence, a provision is recognized for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period as follows:
Probability of warranty cases for the entity where repair/replacement may be required as per past experience
= 1% of Rs. 5,00,00,000 = Rs. 5,00,000
Estimated cost of repair / replacement = Rs. 5,00,000 x 10% = Rs. 50,000.

Question 7: Alloy Fabrication Limited is engaged in manufacturing of iron and steel rods. The company is in the process of finalisation of the accounts for the year ended 31 st March,2022 and needs your advice on the following issues in line with the provisions of AS-29:

I. On 1stApril,2019, the company installed a huge furnace in their plant. The furnace has a lining that needs to be replaced every five years for technical reasons. At the Balance Sheet date 31st March,2022, the company does not provide any provision for replacement of lining of the furnace.

II. A case has been filed against the company in the consumer court and a notice for levy of a penalty of ₹ 50 Lakhs has been received. The company has appointed a lawyer to defend the case for a fee of ₹ 5 Lakhs. 60% of the fees have been paid in advance and rest 40% will be paid after finalization of the case. There are 70% chances that the penalty may not be levied.. (PYP May'22)

Answer:

I. A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is **recognized** as per AS 29. The cost of replacement of lining of furnace is not recognized as a provision because it is a future obligation. Even a legal requirement does not require the company to make a provision for the cost of replacement because there is no present obligation. Even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

II. As per AS 29, 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. 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.
In the given case, there are 70% chances that the penalty may not be levied. Accordingly, Alloy Fabrication Ltd. should not make the provision for penalty. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.
However, a provision should be made for remaining 40% fees of the lawyer amounting₹ 2,00,000 in the financial statements of financial year 2021-2022

Question 8: At the end of the financial year ending on 31stMarch, 2022, 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:

Particulars	Probability	Loss (₹)
In respect of five cases	**100%**	**-**

(Win) Next ten cases (Win)	50%	-
Lose (Low damages)	40%	12,00,000
Lose (High damages)	10%	20,00,000
Remaining five cases	50%	-
Win Lose (Low damages)	30%	10,00,000
Lose (High damages)	20%	21,00,000

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 as per AS - 29. (PYP Nov 22)

Answer:

According to AS 29 (Revised) '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 not 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 50% and for remaining five cases is 50%. As per AS 29 (Revised), 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 remote, 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 = 40% of ₹ 12,00,000 + 10% of ₹ 20,00,000

= ₹ 4,80,000 + ₹ 2,00,000 = 6,80,000

Expected loss in remaining five cases = 30% of ₹ 10,00,000 + 20% of ₹ 21,00,000

= ₹ 3,00,000 + ₹ 4,20,000 = ₹ 7,20,000

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 1,04,00,000 (₹ 6,80,000 X 10 + ₹ 7,20,000 X 5) as contingent liability.

Question 9: During the year, QA Ltd. delivered manufactured products to customer K. The products were faulty and on 1st October, 2023 customer K commenced legal action against the Company claiming damages in respect of losses due to the supply of faulty product. Upon investigating the matter, QA Ltd. discovered that the products were faulty due to defective raw material procured from supplier F. Therefore, on 1st December, 2023, the Company commenced legal action against F claiming damages in respect of the supply of defective raw materials.

QA Ltd. has estimated that it's probability of success of both legal actions, the action of K against QA Ltd. and action of QA Ltd. against F, is very high.

On 1st October, 2023, QA Ltd. has estimated that the damages it would have to pay K would be Rs. 5 crore. This estimate was revised to Rs. 5.2 crore as on 31st March, 2024 and Rs. 5.25 crore as at 15th May, 2024. This case was eventually settled on 1st June, 2022, when the Company paid damages of Rs. 5.3 crore to K.

On 1st December, 2023, QA Ltd. had estimated that it would receive damages of Rs. 3.5 crore

from F. This estimate was revised to Rs. 3.6 crore as at 31st March, 2024 and Rs. 3.7 crore as on 15th May, 2024. This case was eventually settled on 1st June, 2022 when F paid Rs. 3.75 crore to QA Ltd. QA Ltd. had, in its financial statements for the year ended 31st March, 2024, provided Rs. 3.6 crore as the financial statements were approved by the Board of Directors on 26th April, 2024.

(i) Whether the Company is required to make provision for the claim from customer K as per applicable AS? If yes, please give the rationale for the same.

(ii) If the answer to (a) above is yes, what is the entry to be passed in the books of account as on 31st March, 2024?

(iii) What will the accounting treatment of the action of QA Ltd. against supplier F as per applicable AS? (RTP Jan 25)

Answer:

(i) Yes, QA Ltd. is required to make provision for the claim from customer K as per AS 29 since the claim is a present obligation as a result of delivery of faulty goods manufactured. Also, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations. Further, a reliable estimate of Rs. 5.2 crore can be made of the amount of the obligation while preparing the financial statements as on 31st March, 2024.

(ii) Statement of Profit and Loss A/c Dr. Rs. 5.2 crore

To Current Liability A/c Rs. 5.2 crore

(iii) As per para 30 of AS 29, QA Ltd. shall not recognise a contingent asset. Here the probability of success of legal action is very high but there is no concrete evidence which makes the inflow virtually certain. Hence, it will be considered as contingent asset only and shall not be recognized.

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