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## FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

This framework provides the fundamental basis for development of new standards as also for review of existing standards. This framework also explains components of financial statements, users of financial statements, qualitative characteristics of financial statements and elements of financial statements.

The framework also explains concepts of capital, capital maintenance and determination of profit.

### INTRODUCTION

The development of accounting standards or any other accounting guidelines need a foundation of underlying principles. (ASB) of ICAL issued a framework in July, 2000 which provides the fundamental basis for development of new standards as also for review of existing standards.

Nothing in the framework overrides any specific Accounting Standard. In case of conflict between an Accounting Standard and the framework, the requirements of the Accounting Standard will prevail over those of the framework.

The principal areas covered by the framework are as follows:

- (a) Components of financial statements;
- (b) Objectives of financial statements;
- (c) Assumptions underlying financial statements;
- (d) Qualitative characteristics of financial statements;
- (e) Elements of financial statements;

- f) Criteria for recognition of elements in financial statements;
- (g) Concepts of Capital and Capital Maintenance

### COMPONENTS OF FINANCIAL STATEMENTS

A complete set of financial statements normally consists of a Balance Sheet, a Statement of Profit and Loss and a Cash Flow Statement together with notes, other statements and explanatory materials that form an integral part of the financial statements.

All components of the financial statements are interrelated because they reflect different aspects of same transactions or other events. Although each statement provides information that is different from each other, none in isolation is likely to serve any single purpose nor can anyone provide all information needed by a user.

The major information contents of different components of financial statements are explained as below:

Balance Sheet portrays value of economic resources controlled by an enterprise. It also provides information about liquidity and solvency of an enterprise which is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due.

Statement of Profit and Loss presents the result of operations of an enterprise for an accounting period, i.e. it depicts the performance of an enterprise, in particular its profitability.

Cash Flow Statement shows the way an enterprise has generated cash and the way they have been used in an accounting period and helps in evaluating the investing, financing and operating activities during the reporting period.

Notes and other statements present supplementary information explaining different items of financial statements. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They include various other disclosures such as disclosure of accounting policies, segment reporting, related party disclosures, earnings per share, etc.

## OBJECTIVES AND USERS OF FINANCIAL STATEMENTS

The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

The framework identifies seven broad groups of users of financial statements.

All users of financial statements expect the statements to provide useful information needed to make economic decisions. The financial statements provide information to suit the common needs of most users. However, they cannot and do not intend to provide all information that may be needed, e.g. they do not provide non-financial data even if they may be relevant for making decisions.

The aforesaid users use financial statements in order to satisfy some of their information needs. These needs may include the following:

- a) **Investors** - The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.
- b) **Employees** - Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
- c) **Lenders** - Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due
- d) **Suppliers and other trade creditors** - Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.

- e) **Customers** - Customers have an interest in information about the continuance of an enterprise, especially when they have a long term involvement with, or are dependent on, the enterprise for their goods and services.
- f) **Governments and their agencies** - Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.
- g) **Public** - Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

### FUNDAMENTAL ACCOUNTING ASSUMPTIONS

As per the framework, there are three fundamental accounting assumptions:

(a) **Going concern:**

These are assumptions, i.e, the users of financial statements believe that the same has been considered while preparing the financial statements. That is why, as long as financial statements are prepared in accordance with these assumptions, no separate disclosure in financial statements would be necessary.

If nothing has been written about the fundamental accounting assumption in the financial statements, then it is assumed that they have already been followed in their preparation of financial statements.

However, if any of the above-mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

Financial statements are normally prepared on the assumption that an enterprise will continue in operation in the foreseeable future and neither there is an intention, nor there is a need to materially curtail the scale of operations.

(b) **Accrual Basis:**

According to AS 1, revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

Further Section 128(1) of the Companies Act, 2013 makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/ expense is recognised on cash basis, the fact should be stated.

Profit and Loss Account of the trader by two basis of accounting are shown below. A look at the cash basis Profit and Loss Account will convince any reader of the irrationality of cash basis of accounting.

(c) **Consistency:**

It is assumed that accounting policies are consistent from one period to another. The consistency improves comparability of financial statements through time. According to Accounting Standards, an accounting policy can be changed if the change is required (i) by a statute or (ii) by an Accounting Standard or (iii) for more appropriate presentation of financial statements.

## QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. The framework suggests that the financial statements should observe and maintain the following four qualitative characteristics as far as possible within limits of reasonable cost/ benefit.

These attributes can be explained as:

1. **Understandability:** The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities and accounting.
2. **Relevance:** It is not right to think that more information is always better.. A mass of irrelevant information creates confusion and can be even more harmful than

non-disclosure. The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its Materiality

3. **Reliability:** To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless:

Transactions and events reported are faithfully represented.

Transactions and events are reported on the principle of 'substance over form

The reporting of transactions and events are neutral, i.e. free from bias.

Prudence is exercised in reporting uncertain outcome of transactions or events.

4. **Comparability:** Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies.

## ELEMENTS OF FINANCIAL STATEMENTS

The framework classifies items of financial statements in five broad groups depending on their economic characteristics.

1. **Asset:** An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. The following points must be considered while recognising an asset:

The resource regarded as an asset, need not have a physical substance. The resource may represent a right generating future economic benefit,

e.g. patents, copyrights, trade receivables. An asset without physical substance can be either intangible asset, e.g. patents and copyrights or monetary assets, e.g. trade receivables. The monetary assets are money held and assets to be received in fixed or determinable amounts of money.

2. **Liability:** A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits. The following points may be noted:
- (a) A liability is a present obligation, i.e. an obligation the existence of which, based on the evidence available on the balance sheet date is considered probable. For example, an enterprise may have to pay compensation if it loses a damage suit filed against it. The damage suit is pending on the balance sheet date. The enterprise should recognise a liability for damages payable by a charge against profit if it is probable that the enterprise will lose the suit and if the amount of damages payable can be ascertained with reasonable accuracy.
- " Present obligation may be legally enforceable as a consequence of a binding contract or statutory requirement or they may arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.
3. **Equity:** Equity is defined as residual interest in the assets of an enterprise after deducting all its liabilities. It is important to avoid mixing up liabilities with equity. Equity is the excess of aggregate assets of an enterprise over its aggregate liabilities. In other words, equity represents owners' claim consisting of items like capital and reserves, which are clearly distinct from liabilities, i.e. claims of parties other than owners. The value of equity may change either through contribution from / distribution to equity participants or due to income earned /expenses incurred.
4. **Income:** Income is increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants. The definition of income encompasses revenue and gains. Revenue is an income that arises in the ordinary course of activities of the enterprise, e.g. sales by a trader. Gains are income, which may or may not arise in the ordinary course of activity of the enterprise, e.g. profit on disposal of Property, Plant and Equipment. Gains are showed separately in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.
5. **Expense:** An expense is decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants.

The definition of expenses encompasses expenses that arise in the ordinary course of activities of the enterprise, e.g. wages paid. Losses may or may not arise in the ordinary course of activity of the enterprise, e.g. loss on disposal of Property, Plant and Equipment. Losses are separately shown in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.

## MEASUREMENT OF ELEMENTS OF FINANCIAL STATEMENTS

Measurement is the process of determining money value at which an element can be recognised in the balance sheet or statement of profit and loss. The framework recognises four alternative measurement bases. These bases relate explicitly to the valuation of assets and liabilities. The valuation of income or expenses, i.e. profit is implied, by the value of change in assets and liabilities.

A brief explanation of each measurement basis is as follows:

1. **Historical Cost:** Historical cost means acquisition price. For example, the businessman paid ₹ 7,00,000 to purchase the machine, its acquisition price including installation charges is ₹ 8,00,000. The historical cost of machine would be 8,00,000.
2. **Current Cost:** Current cost gives an alternative measurement basis. Assets are carried at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
3. **Realisable (Settlement) Value:** For assets, this is the amount of cash or cash equivalents currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount of cash or cash equivalents expected to be paid on settlement of liability in the normal course of business.
4. **Present Value:** Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

## CAPITAL MAINTENANCE

Capital refers to net assets of a business. Since a business uses its assets for its operations, a fall in net assets will usually mean a fall in its activity level. It is therefore important for any business to maintain its net assets in such a way, as to ensure continued operations at least at the same level year after year. In other words, dividends should not exceed profit after appropriate provisions for replacement of assets consumed in operations. For this reason, the Companies Act does not permit distribution of dividend without providing for depreciation on Property, Plant and Equipment. Unfortunately, this may not be enough in case of rising prices.

A business should ensure that Retained Profit (RP) is not negative, i.e. closing equity should not be less than capital to be maintained, which is sum of opening equity and capital introduced.

It should be clear from above that the value of retained profit depends on the valuation of assets and liabilities. In order to check maintenance of capital, i.e. whether or not retained profit is negative, we can use any of following three bases:

**Financial capital maintenance at historical cost:** Under this convention, opening and closing assets are stated at respective historical costs to ascertain opening and closing equity. If retained profit is greater than or equals to zero, the capital is said to be maintained at historical costs. This means the business will have enough funds to replace its assets at historical costs. This is quite right as long as prices do not rise.

**Financial capital maintenance at current purchasing power:** Under this convention, opening and closing equity at historical costs are restated at closing prices using average price indices. (For example, suppose opening equity at historical cost is ₹3,00,000 and opening price index is 100. The opening equity at closing prices is ₹3,60,000 if closing price index is 120). A positive retained profit by this method means the business has enough funds to replace its assets at average closing price.

This may not serve the purpose because prices of all assets do not change at average rate in real situations. For example, price of a machine can increase by 30% while the average increase is 20%.

Physical capital maintenance at current costs: Under this convention, the historical costs of opening and closing assets are restated at closing prices using specific price indices applicable to each asset. The liabilities are also restated at a value of economic resources to be sacrificed to settle the obligation at current date, i.e. closing date. The opening and closing equity at closing current costs are obtained as an excess of aggregate of current cost values of assets over aggregate of current cost values of liabilities. A positive retained profit by this method ensures retention of funds for replacement of each asset at respective closing prices. pening equity at

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## INTRODUCTION TO ACCOUNTING STANDARDS

### 1. What are Accounting Standards?

Accounting Standards are written policy documents, covering guidelines relating to Issues in Financial Reporting.

### 2. Which Issues are Covered by AS?

AS deals with the following issues:-

- (a) Recognition; (when to recognise a transaction in Books of Accounts)
- (b) Measurement; (At what Value to recognise transactions in Books of Accounts)
- (c) Presentation; (How to present the transactions in the Financial Statements)
- (d) Disclosure;

### 3. WHY AS?

AS are introduced so that there can be:-

- (a) Uniformity;
- (b) Comparability;
- (c) Better Decision Making;

### 4. How Many AS?

At Intermediate Level there are 22 AS to be studied, Of which:-

- AS 1,2,3,10,11,12,13,16 are covered in Paper 1 Accounting;
- AS 4,5,7,9,14,17,18,19,20,21,22,24,26,29 are covered in Paper 5 Advanced Accounting.

### 5. To Whom AS are Applicable?

AS are applicable to ALL Business entities. AS are not applicable to entities engaged in solely Charitable Activities. (e.g. an organisation collecting donations and giving them to flood affected people)

Business Entities are classified as:-

- Corporate entities; (Companies)
- Non-Corporate Entities; (Other than Companies)

**HOMEWORK SECTION**

**Question 1**

What are the issues, with which Accounting Standards deal?

Covered with Classwork Section

**Question 2**

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

Covered with Classwork Section

**Question 3**

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

Covered with Classwork Section

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**HOMEWORK SOLUTIONS**

**Answer 1**

Accounting Standards deal with various critical issues in financial reporting. They provide guidelines for measuring and recognizing assets, liabilities, income, and expenses, ensuring consistency and transparency. These standards also dictate how financial information should be presented in statements and disclosed in notes, promoting uniformity in reporting. They address specific topics like revenue recognition, fair value measurement, leases, and employee benefits, ensuring that financial statements accurately reflect a company's financial position and performance, aiding investors, creditors, and other stakeholders in making informed decisions.

**Answer 2**

Non-company entities which fall in any one or more of the following categories, at the end of the relevant accounting period

- (i) Entities whose securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.
- (ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.
- (iii) All entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees two-fifty crore in the immediately preceding accounting year.
- (iv) Holding and subsidiary entities of any one or the above.

**Question 3**

Non-company entities which are not Level I entities but fall in any one or more of the following categories

- (i) All entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees fifty crore but does not exceed rupees two-fifty crore in the immediately preceding accounting year.
- (ii) All entities engaged in commercial, industrial or business activities, having borrowings (including public deposits) in excess of rupees ten crore but not in excess rupees fifty crore at any time during the immediately preceding accounting year.
- (iii) Holding and subsidiary entities of any one or the above.

PAST PAPER SECTION

**Question 4**

Please explain briefly two benefits and two limitations of Accounting Standards for an accountant. (May'19)

**Question 5**

List the Criteria for classification of non-corporate entities as level I Entities for the purpose of application of Accounting Standards as per the Institute of Chartered Accountants of India.

**Question 6**

List the Criteria for classification of non-corporate entities as level I Entities for the purpose of application of Accounting Standards as per the Institute of Chartered Accountants of India. (Jan' 21)

**Question 7**

What is meant by 'Measurement'? What are the bases of measurement of Elements of Financial Statements? Explain the brief. (Dec' 21)

PAST PAPER SOLUTIONS

**Answer 4**

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

- (i) Standardisation of alternative accounting treatments: Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) Comparability of financial statements: The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditional and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

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

- (i) Difficulties in making choice between different treatments: Alternate solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) Lack of flexibilities and Restricted Scope: There may be a trend towards rigidity and away from flexibility in applying the accounting standards. Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

**Answer 5**

Criteria for classification of non-corporate entities as level 1 entities for purpose of application of Accounting Standards decided by the Institute of Chartered Accountants of India is given below:

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

- (i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.
- (ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

- (iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees two fifty crore in the immediately preceding accounting year.
- (iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees fifty crore at any time during the immediately preceding accounting year.
- (v) Holding and subsidiary entities of any one of the above

### Answer 6

Criteria for classification of non-corporate entities as level 1 entities for purpose of application of Accounting Standards decided by the Institute of Chartered Accountants of India is given below:

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

- (i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.
- (ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.
- (iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees two fifty crore in the immediately preceding accounting year.
- (iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees fifty crore at any time during the immediately preceding accounting year.
- (v) Holding and subsidiary entities of any one of the above

### Answer 7

Measurement is the process of determining money value at which an element can be recognized in the balance sheet or statement of profit and loss. The Framework for Preparation and Presentation of Financial statements recognizes four alternative measurement bases for the purpose of determining the value at which an element can be recognized in the balance sheet or statement of profit and loss.

These bases are: (i) Historical Cost; (ii) Current cost (iii) Realizable (Settlement) Value and (iv) Present Value.

A brief explanation of each measurement basis is as follows:

1. **Historical Cost:** Historical cost means acquisition price. According to this, assets are recorded at an amount of cash or cash equivalent paid or the fair value of the asset at the time of acquisition. Liabilities are generally recorded at the amount of proceeds received in exchange for the obligation.
2. **Current Cost:** Current cost gives an alternative measurement basis. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
3. **Realizable (Settlement) Value:** As per realizable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Liabilities are carried at their settlement values, i.e. the undiscounted amount of cash or cash equivalents paid to satisfy the liabilities in the normal course of business.
4. **Present Value:** Under present value convention, assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities under this convention are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

## AS 1 - DISCLOSURE OF ACCOUNTING POLICIES

### 1. WHAT ARE ACCOUNTING POLICIES?

Accounting policies are rules or principles and methods to adopt such principles in financial accounts for true and fair recording and presentation of financial statements.

### 2. EXAMPLES OF DIFFERENT ACCOUNTING POLICIES:

- Methods of Amortization (AS26)
- Valuation of Inventories (AS 2)
- Valuation of Investments (AS 13)
- Valuation of Fixed Assets (AS10)
- Treatment of Government Grants (AS 12)
- Treatment of Contingent liabilities (AS29)
- Conversion of Foreign currency items (AS 11), etc.

### 3. WHY AS 1?

There is no single list of accounting policies which are applicable in all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable.

If every entity follows separate method to comply with principle then even if they follow the correct accounting policy but still books are not comparable, so there is need for disclosure.

### 4. DISCLOSURE REQUIREMENT :

#### • SIGNIFICANT ACCOUNTING POLICIES:

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

Significant accounting policies means those accounting policies which deals with material items of assets, liabilities, incomes and expenses.

Such disclosure should form part of financial statements.

**These significant accounting policies should be disclosed at one place.**

- **INSIGNIFICANT ACCOUNTING POLICIES:**

All accounting policies relating to immaterial items of assets, liabilities, incomes and expenses need not be disclosed.

- **FUNDAMENTAL ACCOUNTING ASSUMPTIONS:**

Fundamental accounting assumptions form the basis for preparations 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.

**The following are generally accepted fundamental accounting assumptions:**

- **Going concern**

The enterprise is normally viewed as going concern, that is, as continuing in operations for foreseeable future.

It is assumed that enterprise neither has any need nor any will to shut down business in near future. (As per SA 570 going concern issued by the ICAI suggests that foreseeable future means 12 months from the date of financial statements)

- **Consistency:**

It is assumed that accounting policies are consistent from one period to another. However, Consistency is not an excuse to adopt/ continue to adopt inappropriate accounting policies.

- **Accrual:**

It is assumed that revenues and costs are: Recognized as they are earned/ incurred rather than as and when money is received /paid.

Recorded in financial statements of the period to which they relate.

## **5. FACTORS TO BE CONSIDERED WHILE CHOOSING AN ACCOUNTING POLICIES:**

The primary consideration in selection of accounting policies by an enterprise is that financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of state of affairs of enterprise as at balance sheet date and profit/loss for the period ended on that date.

Secondary consideration governing selection and application of accounting policies are:

- **Prudence:**  
Anticipated profits should not be recorded, anticipated losses are to be recorded.
- **Substance over form:**  
The accounting treatment and presentation in financial statements of transaction and events should be governed by their substance and not merely by legal form. Substance refers to economic reality.
- **Materiality:**  
Financial statements should disclose all material items i.e. items the knowledge of which might influence the decisions of the user of financial statements. Determination of materiality is a matter of professional judgement.

#### 6. CHANGES IN ACCOUNTING POLICIES:

Accounting policies can be changed if such change is required by

- Law
- AS
- Management, if they can justify better presentation and preparation of financial statements. Any change that has material effect should be disclosed. The amount by which any item in GPFS is affected by such change should be disclosed. Where such amount is not ascertainable, wholly/ in part, the fact should be indicated.

CLASSWORK QUESTIONS

**Question 1**

In the books of M/s Prashant Ltd., closing inventory as on 31.03.2015 amounts to ₹ 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 2014-15. On the basis of weighted average method, closing inventory as on 31.03.2015 amounts to ₹ 1,47,000. Realisable value of the inventory as on 31.03.2015 amounts to ₹ 1,95,000. Discuss disclosure requirement of change in accounting policy as per AS1.

**Question 2**

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.
- (v) There is no single list of accounting policies which are applicable to all circumstances.

CLASSWORK SOLUTIONS

**Answer 1**

As per para 22 of 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 realisable value. Since net realisable 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. 2014 -15, 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.

**Answer 2**

- (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 at 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.

- (v) True; As per AS 1, there is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable.

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## AS 2 - VALUATION OF INVENTORY

### 1. WHY VALUATION OF INVENTORY IS REQUIRED ?

To know correct Financial Performance (net profit or loss)

And

To know True & fair Financial Position

Since, Appropriate / In-appropriate valuation of inventory affects both the profit / loss from operations & financial position as reflected in the Balance Sheet.

### 2. MEANING / DEFINITION OF INVENTORY As Per AS-2 :

According to AS 2, Inventories are assets

- (a) held for sale in the ordinary course of business or
- (b) in the process of production for such sale or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services

### 3. INVENTORIES INCLUDES :

Thus, Inventory consists of :

- (a) Goods purchased & held for re-sale
- (b) Finished goods produced for sale
- (c) Work in progress
- (d) Stores, spares, loose tools etc. awaiting use in production process (of goods meant for sale)

### 4. AS 2 DOES NOT COVER :

- (a) Financial instruments such as shares, debentures etc. held as stock
- (b) Work in progress under construction contracts
- (c) Work in progress arising in the ordinary course of business of service providers
- (d) Live stock, agricultural & forest products, mineral oils (for whose valuation certain established practices may exist)

### 5. VALUATION :

Inventories are valued at COST or NRV, whichever is less.

## 6. COST INCLUDES :

- Cost = Purchase cost + conversion cost + other costs incurred to bring the inventory to its present location & condition
- Purchase cost = purchase price + duties & taxes + freight inward + other directly attributable expenses (like in-transit insurance) – (duties & taxes recoverable + trade discount & rebates etc.).
- Conversion cost = Direct labour + variable production overheads (calculated on actual production) + fixed production overheads (calculated on normal capacity)
- In case of joint products, the conversion cost is allocated on rational & consistent basis (e.g. : sales).
- In case of by products, the NRV of by product is deducted from the conversion cost
- Inventory Cost does not include : Administration cost, Selling & distribution cost, abnormal wastage, storage costs etc.
- Normal capacity means the production expected to be achieved on an average over a number of periods under normal conditions. Fixed production overheads per unit will be revised if actual production exceeds normal capacity so that inventories are not measured above their cost.
- Interest & other borrowing costs are usually not included in inventory valuation. However, they can be included if time plays a major factor in bringing about a change in the condition of inventories.

## 7. METHODS OF INVENTORY VALUATION :

- (a) Inventory not ordinarily interchangeable: specific identification method : Specific identification method tracks the actual physical flow of goods. It is also called the actual cost method because specific job bears the actual cost of materials bought for the job. This method is suited for antique shops, expensive jewellery, custom-made merchandise etc.
- (b) Inventory ordinarily interchangeable: FIFO or weighted avg. method
- Other methods allowed are standard cost method or retail price method if it were to result in estimation of value of inventory that approximates the actual cost. Standard cost is a pre-determined cost based on attainable efficiency standard for a given volume of output. Retail price method is generally adopted by retail stores having numerous low unit cost items. Cost is measured by deducting gross margin from retail prices of year end inventory.

**8. NRV :**

NRV = estimated selling price in the ordinary course of business – estimated cost of completion – estimated costs necessary to make the sale. Considerations governing estimation of NRV are :

- (a) Most reliable evidence available at the time estimates are made as to amounts that inventories are expected to realize &
- (b) Fluctuations of prices or costs directly relating to events occurring after the Balance Sheet date, to the extent that such events confirm the conditions existing at the Balance Sheet date.

**9. VALUATION OF MATERIAL :**

Materials & other supplies held for use in production are not written down below the cost if finished goods in which they will be used are expected to be sold at or above cost. When finished goods are not expected to fetch the cost & there is a decline in process of material & other supplies then the materials & other supplies are written down to their NRV. In such a case, the replacement cost is the NRV.

**10. DISCLOSURES REQUIRED :**

- (a) Accounting policy applied in measuring inventories including cost formula
- (b) Carrying amount of inventory classified appropriately e.g. finished goods, work in progress, raw material, spare parts, loose tools etc.
- (c) Any changes in accounting policy with respect to valuation of inventory & its effect on the financial statements.

CLASSWORK QUESTIONS

**Question 1**

Calculate the value of raw materials and closing stock based on the following information:

Raw material X	
Closing balance	500 units
	₹ per unit
Cost price including excise duty	200
Excise duty (Cenvat credit is receivable on the excise duty paid)	10
Freight inward	20
Unloading charges	10
Replacement cost	150
Finished goods Y	
Closing Balance	1200 units
	₹ per unit
Material consumed	220
Direct labour	60
Direct overhead	40

Total Fixed overhead for the year was ₹ 2,00,000 on normal capacity of 20,000 units.

Calculate the value of the closing stock, when

- (i) Net realizable value of the finished goods Y is ₹ 400
- (ii) Net Realizable value of the finished goods Y is ₹ 300

**Question 2**

SM Enterprises is a leading distributor of petrol. A detail inventory of petrol in hand is taken when the books are closed at the end of each month. For the end month of 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 litres @ ₹ 92 per litre.
- (iv) Purchases - June 1 2021, 20,000 litres @ ₹ 90 per litre, June 30 2021, 10,000 litres @ ₹ 95 per litre.
- (v) Closing inventory 13,000 litres.

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.

(May '22)

**Question 3**

Raw materials inventory of a company includes certain material purchased at ₹ 100 per kg. The price of the material is on decline and replacement cost of the inventory at the year-end is ₹ 75 per kg. It is possible to convert the material into finished product at conversion cost of ₹ 125.

Decide whether to make the product or not to make the product, if selling price is

- (i) ₹ 175 and (ii) ₹ 225. Also find out the value of inventory each case.

(May'10)

CLASSWORK SOLUTIONS

Answer 1

(i) Calculation of cost p.u. of Raw material X

	₹ per unit
Purchase price	200
(-) Refundable excise duty	(10)
(+) freight inward	20
(+) Unloading charges	10
Total cost per unit	220

Calculation of cost p.u. of Finished Goods Y

	₹ per unit
Direct Material	220
(+) Direct Labour	60
(+) Direct Overheads	40
(+) Fixed Overheads (2,00,000/20,000)	10
Total cost per unit	330

NRV of Finished goods Y = ₹400 p.u.

Since NRV > Cost of FG, FG Y will be valued at cost of ₹ 330. p.u. & RM X will be valued at cost of ₹ 220 p.u.

∴ Value of inventory -

(a) FG Y = 1,200 units x ₹330 p.u. = ₹ 3,96,000

(b) RM X = 500 units x ₹220 p.u. = ₹ 1,10,000

Total value = ₹ 5,06,000

(ii) NRV of Finished goods Y = ₹300 p.u.

Since NRV < cost of FG, FG Y will be valued at NRV of ₹ 300 p.u. & Rm X will be valued at Replacement cost of ₹ 150 p.u.

∴ value of inventory

(a) FG Y = 1,200 units x ₹300 p.u. = ₹ 3,60,000

(b) RM X = 500 units x ₹ 150 p.u. = ₹ 75,000

Total value = ₹4,35,000

**Answer 2**

	₹
Cost of closing inventory for 13,000 litres as on 30th June 2021	
10,000 litres @ ₹ 95	9,50,000
3,000 litres @ ₹ 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 litres @ ₹ 92)	9,20,000
Purchases June – 1 (20,000 litres @ ₹ 90)	18,00,000
June – 30 (10,000 litres @ ₹ 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

**Answer 3**

As per para 24 of AS 2 ‘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 realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

(i) When selling price is ₹ 175

Incremental Profit = ₹ 175 – ₹ 125 = ₹ 50 Current price of the material = ₹ 75

Therefore, it is better not to make the product. Raw material inventory would be valued at net realisable value i.e. ₹ 75 because the selling price of the finished product is less than ₹225 (100+125) per kg.

(ii) When selling price is ₹225

Incremental Profit = ₹ 225 – ₹ 125 = ₹ 100

Current price of the raw material = ₹ 75.

Therefore, it is better to make the product.

Raw material inventory would be valued at ₹100 per kg because the selling price of the finished product is not less than ₹ 225.

## AS 3 - CASH FLOW STATEMENT

### THEORY SECTION

1. Cash Flow Statement shows relationship between Profitability and Cash generating ability and hence the "quality of profits" of the reporting entity.
2. It is mandatory for listed companies and entities with a turnover exceeding ₹ 50 crores.
3. Cash comprises cash on hand & demand deposits with bank.  
Cash equivalents are short term highly liquid investments that are readily convertible into known amounts of cash & which are subject to an insignificant risk.
4. **Classification of Activities:** According to the revised Accounting Standard 3, the cash flow statement should show cash flows during the period classified by operating, investing & financing activities.
  - (a) **Operating Activities:** These are principle revenue producing activities of an enterprise other activities which are not investing or financing activities. Cash flows from operating activities generally result from the transactions & other events that determine the net profit or loss of the business. e.g. of cash flows from Operating activities are :
    - (i) Cash receipts from sale of goods & rendering of services.
    - (ii) Cash Receipts from commission, fees, royalties etc.
    - (iii) Cash payments suppliers of goods & services.
    - (iv) Cash payments of operating expenses such as salaries & wages, rent, electricity etc.
    - (v) Cash payments or refund of income tax.
  - (b) **Investing Activities:** These are acquisition & disposal of Long-term assets such as land, building, plant, furniture, goodwill, trademarks, copyrights and investments not included in cash equivalents e.g.
    - (i) Cash payments to acquire fixed assets.

- (ii) Cash payments relating to capitalisation research & development cost.
- (iii) Cash received on disposal of fixed assets.
- (iv) Loans made to third parties.
- (v) Cash received from repayments of loans made to third parties.
- (vi) Interest received on investments / Income from investment.

(c) **Financing Activities:** These are activities that result in changes in the size and composition of owners capital including preference share capital & borrowings of a business e.g.

- (i) Cash receipts from issue of shares, debts, bonds, loans & other borrowings.
- (ii) Cash repayment of loans taken.
- (iii) Cash payment to redeem preference shares.
- (iv) Interest and dividend paid.

5. Net basis reporting is allowed in following situations.

- (a) Cash Flows reflecting activities of customers rather than those of the reporting entity (e.g. deposits and withdrawals by a bank's customers).
- (b) Cash Flows in respect of items in which the taken over is quick and amounts are large and maturities are short (e.g. principal amounts relating to credit card customers).

The AS-3 (Revised) "Cash Flow Statement" has prescribed two formats for the presentation of Cash Flow Statement. These formats are given in Tables.

**CASH FLOW STATEMENT [PARAGRAPH 18 (A)] (DIRECT METHOD)**

<b>Cash flows from Operating Activities</b>		
Cash receipts from Customers	*****	
Cash paid to suppliers and employees	(*****)	
Cash generated from operations	*****	
Income Tax paid	(*****)	
Cash flow before extraordinary item	*****	
± Extraordinary Items	*****	
Net cash from Operating Activities		*****
<b>Cash flows from Investing Activities</b>		
Purchase of fixed assets	(*****)	
Proceed from sale of equipment	*****	
Interest received	*****	
Dividend received	*****	
Net cash from investing activities	*****	
<b>Cash flows from Financing Activities</b>		
Proceeds from issuance of share capital	*****	
Proceeds from long-term borrowings/short - term borrowings	*****	
Repayments of long - term borrowings	(*****)	
Interest paid	(*****)	
Dividend paid	(*****)	
Net cash from financing activities		*****
Net increase in cash and cash equivalents		*****
Cash and cash equivalents at beginnings of period		*****
Cash and cash equivalents at end of period		*****

**CASH FLOW STATEMENT [PARAGRAPH 18 (B)] (INDIRECT METHOD)**

<b>Cash flows from Operating Activities</b>		
Net profits before taxation and extraordinary item	*****	
<b>Adjustment for :</b>		
Depreciation	*****	
Interest Income	*****	
Dividend Income	*****	
Interest expense	*****	
Operating profit before working capital changes	*****	
Increase in sundry debtors	(*****)	
Decrease in inventories	*****	
Decrease in sundry creditors	*****	
Cash generated from operations	*****	
Income tax paid	(*****)	
Cash flow before extraordinary items	*****	
± Extraordinary items	*****	
Net cash from operating activities		*****
<b>Cash flow from Investing Activities</b>		
Purchase of fixed assets	(*****)	
Proceeds from sale of equipment	*****	
Interest received	*****	
Dividend received	*****	
Net cash from operating activities		*****
<b>Cash flow from Financing Activities</b>		
Proceeds from issuance of share capital	*****	
Proceeds from long – term borrowings / short – term borrowings	*****	
Repayment of long - term borrowings	(*****)	
Interest paid	(*****)	
Dividend paid	(*****)	
Net cash from financing activities		*****
Net increase in cash and cash equivalents		*****
Cash and cash equivalents at beginning of period		*****
Cash and cash equivalents at end of period		*****

CLASSWORK SECTION

Question 1

The following data were provided by the accounting records of Ryan Ltd. at year-end, March 31, 2013:

Income Statement

	₹
Sales	6,98,000
Cost of Goods Sold	5,20,000
Gross Margin	1,78,000
Operating Expenses (including Depreciation Exp. of ₹ 37,000)	(1,47,000)
	31,000
<u>Other Income (Expenses)</u>	
Interest Expense paid	(23,000)
Interest Income received	6,000
Gain on Sale of Investments	12,000
Loss on Sale of Plant	(3,000)
	23,000
Income tax	(7,000)
	<b>16,000</b>

Comparative Balance Sheets

	₹	₹
	31 <sup>st</sup> March 2013	31 <sup>st</sup> March 2012
Assets		
Plant Assets	7,15,000	5,05,000
Less: Accumulated Depreciation	(1,03,000)	(68,000)
	6,12,000	4,37,000
Investments (Long - term)	1,15,000	1,27,000
Current Assets		
Inventory	1,44,000	1,10,000
Accounts Receivable	47,000	55,000
Cash	46,000	15,000
Prepaid Expenses	1,000	5,000
	<b>9,65,000</b>	<b>7,49,000</b>

<b>Liabilities</b>		
Share Capital	4,65,000	3,15,000
Reserves & Surplus	1,40,000	1,32,000
Bonds	2,95,000	2,45,000
<b>Current Liabilities:</b>		
Accounts Payable	50,000	43,000
Accrued Liabilities	12,000	9,000
Income Taxes Payable	3,000	5,000
	<b>9,65,000</b>	<b>7,49,000</b>

Analysis of selected accounts and transactions during 2012-2013:

1. Purchased investments for ₹ 78,000.
2. Sold investments costing ₹ 90,000.
3. Purchased plant assets for ₹ 1,20,000
4. Sold plant assets that cost ₹ 10,000 with accumulated depreciation of ₹ 2,000 for ₹ 5,000.
5. Issued ₹ 1,00,000 of bonds at face value in a exchange for plant assets on 31st March, 2013.
6. Repaid ₹ 50,000 of bonds at face value at maturity.
7. Issued 15,000 shares of ₹10 each.

Prepare Cash Flow Statement as per AS-3 (Revised), using indirect and direct method.

CLASSWORK SOLUTIONS

Answer 1

Ryan Ltd.

Cash Flow Statement

for the year ending 31st March, 20X1

	₹	₹
Cash flows from operating activities		
Net profit before taxation	23,000	
Adjustments for:		
Depreciation	37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Interest expense	23,000	
Interest income	(6,000)	
Operating profit before working capital changes	68,000	
Decrease in trade receivables	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	
Increase in trade payables	7,000	
Increase in outstanding liabilities	3,000	
Cash generated from operations	56,000	
Income taxes paid*	(9,000)	
Net cash generated from operating activities		47,000
<b>Cash flows from investing activities</b>		
Purchase of plant	(1,20,000)	
Sale of plant	5,000	
Purchase of investments	(78,000)	
Sale of investments	1,02,000	
Interest received	6,000	
Net cash used in investing activities		(85,000)
Cash flows from financing activities		
Proceeds from issuance of share capital	1,50,000	
Repayment of bonds	(50,000)	
Interest paid	(23,000)	
Dividends paid	(8,000)	
Net cash from financing activities		69,000
Net increase in cash and cash equivalents		31,000
Cash and cash equivalents at the beginning of the period		15,000
Cash and cash equivalents at the end of the period		46,000

**\*Working Note:**

Income taxes paid:	₹
Income tax expense for the year	7,000
Add: Income tax liability at the beginning of the year	5,000
	<hr/>
	12,000
Less: Income tax liability at the end of the year	(3,000)
	<hr/>
	9,000
	<hr/>

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## AS 4 - CONTINGENCIES & EVENTS OCCURRING AFTER BALANCE SHEET DATE

### 1. MEANING:

Post Balance Sheet events are those that occur between Balance Sheet date & the date on which the financial statements are approved.

### 2. Events occurring after Balance Sheet date fall under 2 categories :

- (a) Events that require adjustment of Assets & Liabilities (Adjusting event)
- (b) Other events, financial impact of which requires a disclosure (Non Adjusting event).

### 3. ADJUSTING EVENTS :

- (a) Adjusting events provide additional evidence that assist in estimation of amounts relating to conditions existing on the Balance Sheet date. For e.g.:

Elements constituting the principle	Example
1. Condition already existing on the Balance Sheet date	non-payment by a debtor
2. Additional evidence surfacing after Balance Sheet date	debtor declared insolvent by court
3. Post balance sheet event	Insolvency of debtor
4. Quantification of amount	Debts due less likely recovery
5. Adjustment to be made	Provision for bad debts

- (b) Adjusting events may provide evidence that the Fundamental Accounting Assumption of going concern is not appropriate.

### 4. NON-ADJUSTING EVENTS:

Non-adjusting events do not affect Balance Sheet figures but the impact of these events have to be appropriately disclosed (in the Directors' report)

Elements constituting the principle	Example
1. Post Balance sheet event	Amalgamation
2. Financial impact of event	Material changes in commitments affecting the financial position
3. Quantification of amount	Estimate the amount where possible
4. Disclosure to be made	In the Director's report
5. Contents of disclosure	Nature of event & estimate of financial effect (or an explicit statement that the financial impact cannot be quantified)

## 5. EXAMPLES OF ADJUSTING & NON-ADJUSTING EVENTS :

### Adjusting events:

- Subsequent determination of proceeds of sale of FAs purchased or sold before year end.
- Property valuation that provides evidence of a permanent decrease in value.
- Evidence regarding  $NRV < cost$
- Retrospective changes in tax rates.
- Discovery of error or fraud

### Non-adjusting events that occur after year end :

- Mergers or acquisitions, investment or reconstruction
- Issue of shares
- Extension of activities
- Changes in exchange rates

CLASSWORK QUESTIONS

**Question 1**

Which of the following event should be taken into account while finalizing (on 30th September, 2011) the annual accounts for the year ending March 31, 2011

- (a) One of the several factories destroyed by fire on July 28, 2011.
- (b) A debtor against whom insolvency proceedings were instituted prior to March 31, 2011 is declared insolvent on July 21, 2011.
- (c) A theft of cash of ₹ 1 crore by the Cashier in Jan. 2011 was detected on 17th May 2011.
- (d) The factory of the entrepreneur is permanently sealed under Supreme Court order since it was polluting industry on September 20, 2011.
- (e) A major debtor died on May 13, 2011.
- (f) A fire occurred in the godown on April 1 2011, damaging a huge quantity of stocks.

**Question 2**

**Comment on the following:**

A company follows April–March as its financial year. The company recognizes cheques dated 31st March or before, received from customers after balance sheet date but before approval of financial statement by debiting Cheques in hand A/c and crediting the Debtors A/c. The Cheques in hand is shown in balance sheet as an item of cash and cash equivalents. All Cheques in hand are presented to bank in the month of April and are also realised in the same month in normal course after deposit in the bank.

**Question 3**

You are an accountant preparing accounts of A Ltd. as on 31.3.2011. After year end the following events have taken place in April, 2011:

- (i) A fire broke out in the premises damaging, uninsured stock worth ₹10 lakhs (Salvage value ₹ 2 lakhs).
- (ii) A suit against the company's advertisement was filed by a party claiming damage of ₹ 20 lakhs.

Describe, how above will be dealt with in the accounts of the company for the year ended on 31.3.2011.

CLASSWORK SOLUTIONS

Answer 1

Events	Accounting Treatment
(a)	<p>Disclosure should be made in the report of the approving authority if the amount of loss is considered material.</p> <p>Such loss should not be recognized in the financial statements for the year 2010-11 since such event does not relate to the conditions existing at the Balance Sheet Date.</p>
(b)	<p>Debtors should be reduced by the amount of bad debts.</p> <p><b>Reason:</b> As per AS 4 Assets and liabilities should be adjusted for event 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.</p>
(c)	<p>Loss due to theft should be recognised.</p> <p><b>Reason.</b> As per AS 4 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.</p>
(d)	<p>The financial statements should be prepared by not following the fundamental assumption of going concern.</p> <p><b>Reason:</b> As per AS – 4, assets and liabilities should be adjusted for events occurring after the balance sheet date that indicates that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate</p>
(e)	<p>Disclosure should be made in the report of the approving authority since the amount of loss is material.</p> <p>Such loss should not recognized in the financial statement for the year 2010-11 since such event does not relate to the condition existing at the Balance Sheet Date.</p>
(f)	<p>Disclosure should be made in the report of the approving authority since the amount of loss is material.</p> <p>Such loss should not recognized in the financial statement for the year 2010-11 since such event does not relate to the condition existing at the Balance Sheet Date.</p>

**Answer 2**

Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on 31st March. Thus the collection of cheques after balance sheet date is not an adjusting event. 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 so no disclosure of such collections in the Directors' Report is necessary.

It should also be noted that, the Framework for Preparation and Presentation of Financial Statement defines assets as resources controlled by an enterprise as a result of past events from which economic benefits are expected to flow to the enterprise. Since the company acquires custody of the cheques after 31st March, it does not have any control over the cheques on 31st March and hence cheques in hand do not qualify to be recognized as assets on 31st March.

**Answer 3**

Events occurring after the Balance Sheet date that represent material changes and commitments affecting the financial position of the enterprise must be disclosed according to para 15 of AS 4 on 'Contingencies and Events Occurring after the Balance Sheet Date'. The key point here is whether the impact of the loss is material or not. As the loss has arisen from non-insurance the event becomes very material not merely on account of the current loss but the future vulnerability. Hence, fire accident and loss thereof must be disclosed as also the fact that the stocks of the company are uninsured with a value of the future risk (if possible). Suit filed against the company being a contingent liability must be disclosed with the nature of contingency, an estimate of the financial effect and uncertainties which may affect the future outcome must be disclosed as per para 16 of AS 4.

## AS 5 - NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICY

### 1. NET PROFIT OR LOSS FOR THE PERIOD INCLUDES :

All items of income and expense including extra ordinary items and effects of changes in accounting estimates which are recognized in a period.

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

- Profit or loss from ordinary activities and
- Profit or loss from extra ordinary activities.

Any activities which are undertaken by an enterprise as a part of its business and Such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

When the items of income and expense 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.

**Following are items of income/expense which require separate disclosure:**

- (a) The write down of inventories to NRV
- (b) Disposal of fixed assets
- (c) Disposal of long term investments
- (d) Litigation settlements, etc.

**Profit or loss from extra ordinary activities:**

Extra ordinary items are incomes or expenses that arise from events or transactions that are clearly distinct from ordinary activities of the enterprise and, therefore, are not expected to occur frequently. The nature and amount of each extraordinary items should be separately disclosed in the statement of profit or loss in a manner that its impact on profit or loss can be perceived.

**Examples of extraordinary items:**

- (a) Loss due to earthquake
- (b) Attachment of property
- (c) Government Grants becoming refundable
- (d) Loss due to fire
- (e) Loss due to enemy attack, etc.

**2. CHANGES IN ACCOUNTING ESTIMATES :**

As a result of the uncertainties inherent in business activities, many financial statements items cannot be measured with precision but can only be estimated based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or lives of assets.

The estimates can be revised if-

Changes occur regarding the circumstances on which the estimates are based As a result of new information, more experience or subsequent developments.

NOTE: Revision of accounting estimates is not an extra-ordinary item or a prior period item. Classification of change in accounting estimates:

The effect of a change in an accounting estimate should be classified under the same classification in the statement of profit or loss as was used previously for the estimate.

The effect of a change in an accounting estimate which was previously included in profit or loss from ordinary activities is included in that component of net profit or loss.

The effect of a change in an accounting estimate which was previously included in profit or loss as extra-ordinary item is reported as extra-ordinary item.

**3. CHANGES IN ACCOUNTING POLICIES:**

Accounting policies can be changed if such change is required by

- Law
- AS
- Management, if they can justify better presentation and preparation of financial statements. Any change that has material effect should be disclosed.

The amount by which any item in GPFs is affected by such change should be disclosed. Where such amount is not ascertainable, wholly/ in part, the fact should be indicated.

**The following are not changes in accounting policies:**

- The adoption of a new accounting policy for events or transactions that differ in substance from previously occurring events or transactions.
- The adoption of a new accounting policy for events or transactions which did not occur previously or that were material.

**4. Prior period items:**

Prior period items are incomes or expenses which arises in current period as a result of error or omissions in the preparation of financial statements of one or more prior periods. Errors may be occur as a result of:

- Mathematical mistakes,
- Mistakes in applying accounting policies,
- Misinterpretation of facts, or
- Oversight.

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

**Examples of prior period item:**

- (a) Error in calculation of depreciation
- (b) Use of incorrect rates of depreciation
- (c) Omission to provide depreciation Non provision for bad/doubtful debts, etc

CLASSWORK QUESTIONS

**Question 1**

Advise B Co. Ltd. about the treatment of the following in the financial statement of accounts for the year ended 31st March 2012:

The company finds that the stock sheets as on 31st March 2011 had included twice an item the cost of which was ₹ 55,000

**Question 2**

X Co. Ltd. signed an agreement with its employees union for revision of wages in June, 2012. The wage revision is with retrospective effect from 1.4.2008. The arrear wages upto 31.3.2012 amounts to ₹ 80 lakhs. Arrear wages for the period from 1.4.2012 to 30.06.2012 (being the date of agreement) amounts to ₹ 7 lakhs.

Decide whether a separate disclosure of arrear wages is required.

**Question 3**

Closing Stock for the year ending on 31st March, 2013 is ₹1,50,000 which includes stock damaged in a fire in 2011-12. On 31st March, 2012, the estimated net realizable value of the damaged stock was ₹ 12,000. The revised estimate of net realizable value of damaged stock included in closing stock at 2012-13 is ₹ 4,000. Find the value of closing stock to be shown in Profit and Loss Account for the year 2012-13, using provisions of Accounting Standard 5.

CLASSWORK SOLUTIONS

**Answer 1**

As per AS – 5 Prior period items are incomes or expenses, which arise in the current period as a result of errors or omissions in the preparation of financial statement of one or more prior periods.

Hence Rectification of Error in opening stock valuation is a prior period item.

The amount of ₹ 55,000 shall be deducted from the opening stock in the profit & loss account for the current year and should also be charged as prior period adjustment in the Profit & Loss account, below the line.

As 5 requires separate disclosure of prior period item with their nature and amount.

**Answer 2**

It is given that revision of wages took place in June, 2012 with retrospective effect from 1.4.2008. The arrear wages payable for the period from 1.4.2008 to 31.3.2012 cannot be taken as an error or omission in the preparation of financial statements of earlier years and hence this expenditure cannot be taken as a prior period item.

Additional wages liability of ₹ 87 lakhs {from 1.4.2008 to 30.6.2012} should be included in current year's wages. It may be mentioned that additional wages is an expense arising from the ordinary activities of the company.

Although abnormal in amount, such an expense do not qualify as an extraordinary item. However, as per AS 5, 'Net Profit or Loss for the Period, Prior Period Items and changes in the Accounting Policies', 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.

However, wages payable for the current year {from 1.4.2012 to 30.6.2012} amounting ₹ 7 lakhs is not a prior period item hence need not be disclosed separately. This may be shown as current year's wages.

**Answer 3**

The fall in estimated net realisable value of damaged stock ₹ 8,000 is the effect of change in accounting estimate. As per AS 5 'Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies', the effect of a 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. It is presumed that the loss by fire in the year ended

31.3.2012, i.e. difference of cost and NRV was shown in the profit and loss account as an extra-ordinary items.

Therefore, in the year 2012-13, revision in accounting estimate should also be classified as extra-ordinary items in the profit and loss account and closing stock should be shown excluding the value of damaged stock.

Value of closing stock for the year 2012-13 will be as follows.

		₹
Closing Stock of Normal goods		1,38,000
Stock of Abnormal goods	12,000	
Less: decline in NRV (extra-ordinary item)	(8,000)	4,000

## AS 7 - CONSTRUCTION CONTRACT

### 1. APPLICABILITY :

AS 7 addresses the issue of allocation of revenue & costs attributable to contract activity to the accounting period in which construction work is performed.

### 2. DEFINITION :

A construction contract is defined as a contract specifically negotiated for the construction of an asset or combination of assets that are closely inter-related or inter-dependent in terms of their design, technology & function or their ultimate purpose or use e.g. :- contract for construction of a bridge, building, dam, pipeline, road etc. Construction contracts also include contract for rendering services relating to construction of assets (e.g. :- service of architect) & contracts for destruction or restoration of asset & restoration of environment following demolition of asset.

### 3. TYPES OF CONSTRUCTION CONTRACTS :

Construction contracts are of the following 2 types:

- (a) Fixed price construction contracts : are those in which parties agree to a fixed price or fixed rate per unit & in some cases subject to escalation clause
- (b) Cost plus construction contracts : are those which involves reimbursement of defined costs plus a percentage of such cost or a fixed fee.

Cost plus contracts involving a maximum ceiling would bear the characteristics of both the above types.

### 4. ADDITIONAL ASSET :

Construction contracts may provide for construction of additional asset at the option of the customer. The construction of additional asset should be treated as a separate contract if the asset differs significantly from the asset covered by the original contract & the price of the additional asset is independent of the original contract price.

## 5. PROFIT OR LOSS ON CONTRACT :

Profit / Loss is to be calculated for each contract separately but when a group of contracts have been negotiated as a single package with an overall profit margin then all such contracts put together would be treated as a single contract.

To calculate the contract profit/loss, contract revenue & costs must be calculated.

➤ **Contract revenue consists of :**

- (a) Agreed price
- (b) Claims arising due to escalation clause
- (c) Claims for re-imburement of costs not included in the contract price
- (d) Increase or decrease in revenue due to change or variation in scope of work to be performed
- (e) Incentives (additional amounts paid if performance exceeds agreed targets)

➤ **Contract costs consists of the following :**

- (a) Direct or specific costs : Direct materials, direct labour & direct expenses
- (b) Allocable costs : Insurance, design & technical assistance expenditure etc. specifically chargeable under the contract

➤ **Following costs are excluded from contract costs :**

- (a) General administration cost
  - (b) Selling costs
  - (c) R & D costs
  - (d) Depreciation on idle plant & equipment
- Costs incurred in securing contracts & pre-contract costs are included in the contract costs if it is probable that contract will be obtained. Otherwise they should be charged to the General P & L A/c.
- Interest cost can be included in contract costs if the asset is a qualifying asset as per AS – 16.

## 6. RECOGNITION OF CONTRACT COST & REVENUE :

When the outcome of the contract can be estimated reliably then contract revenue & related costs are recognized as revenue & costs by reference to the stage of completion of the contract activity at the Balance Sheet date. This is also called Percentage Completion Method (PCM). The stage of completion can be determined in a variety of ways:

- (a) Cost to cost method: Compare the total cost incurred to date with the total estimated cost of the contract. Therefore,

$$\% \text{ of completion} = \frac{\text{cost incurred till date}}{(\text{cost incurred till date} + \text{cost likely to be incurred for completion})} \times 100$$

- (b) Survey of work performed
- (c) Completion of a physical proportion of the contract work.
- Contract revenue recognition = (Contract price\* % of completion) – Revenue recognized earlier.

### 7. PROVISION FOR EXPECTED LOSS :

When it is probable that total contract costs will exceed total contract revenue, expected loss should be recognized as an expense immediately irrespective of

- (a) Whether or not work has commenced
  - (b) The stage of completion
  - (c) The amount of profit on other contracts which are not treated as a single contract
8. When the outcome of a contract cannot be reliably estimated then revenue should be recognized only to the extent of costs incurred & of which recovery is possible. Recognition of revenue & expenditure in construction contracts is based on estimates. Changes in estimates in year- to-year are accounted as a change in accounting estimate as per AS 5. This change will neither be a PPI nor an extra-ordinary item.

### 9. DISCLOSURE :

An enterprise should disclose the method used to determine the stage of completion & method used to determine contract revenue. In addition to the policy disclosure, the following disclosures are also required :

- (a) Amount of contract revenue recognized during the period
- (b) Contract cost incurred & recognition of profit
- (c) Advance received
- (d) Gross amount due from (Costs Incurred + Recognised Profit - Recognised Losses - Progressive Due from customer)
- (e) Gross amount due to customers (Progressive Billing + Recognised Losses - Recognised Profit - Costs Incurred)
- (f) Retentions

CLASSWORK QUESTIONS

**Question 1**

Akar Ltd. Signed on 01/04/16, a construction contract for ₹ 1,50,00,000. Following particulars are extracted in respect of contract, for the period ending 31/03/17.

- Materials issued ₹ 75,00,000
- Labour charges paid ₹ 36,00,000
- Hire charges of plant ₹ 10,00,000
- Other contract cost incurred ₹ 15,00,000
- Out of material issued, material lying unused at the end of period is ₹ 4,00,000
- Labour charges of ₹ 2,00,000 are still outstanding on 31.3.17.
- It is estimated that by spending further ₹ 33,50,000 the work can be completed in all respect.

You are required to compute profit/loss to be taken to Profit & Loss Account and additional provision for foreseeable loss as per AS-7.

**Question 2**

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

	(Amount ₹ in lacs)		
	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 ₹ 100 lacs for standard materials stored at the site to be used in year 3 to complete the work.

\*\* Excludes ₹ 100 lacs 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).

**Question 3**

Sarita Construction Co obtained a contract for construction of a dam. The following details are available in records of company for the year ended 31st March, 2018:

	₹ in lakhs
Total Contract Price	12,000
Work Certified	6,250
Work not certified	1,250
Estimated further cost to completion	8,750
Progress payment received	5,500
Progress payment to be received	1,500

Applying the provisions of Accounting Standard 7 "Accounting for Construction Contracts" you are required to compute:

- (i) Profit/Loss for the year ended 31st March, 2018.
- (ii) Contract work in progress as at end of financial year 2017-18.
- (iii) Revenue to be recognized out of the total contract value.
- (iv) Amount due from/to customers as at the year end.

(May'18)

CLASSWORK SOLUTIONS

Answer 1

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	₹	₹
Material Issued	75,00,000	
Less: Unused Material at the end of period	4,00,000*	71,00,000
Labour Charges paid	36,00,000	
Add: Outstanding on 31.03.2017	2,00,000	38,00,000
Hire Charges of Plant		10,00,000
Other Contract cost incurred		15,00,000
Cost incurred upto 31.03.2017		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 × 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

- Unused material amounting ₹4,00,000 is considered to be included in amount of ₹33,50,000 (estimated future cost).

Answer 2

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

(Amount in ₹ lakhs)

	Up to the reporting date	Recognized in previous years	Recognized in current year
<b>Year 1</b>			
Revenue (9,000 × 26%)	2,340	-	2,340
Expenses (8,050 × 26%)	2,093	-	2,093
Profit	247	-	247

<b>Year 2</b>			
Revenue (9,200 × 74%)	6,808	2,340	4,468
Expenses (8,200 × 74%)	6,068	2,093	3,975
Profit	740	247	493
<b>Year 3</b>			
Revenue (9,200 × 100%)	9,200	6,808	2,392
Expenses (8,200 × 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 (8)	2,093	6,068	8,200
Degree of completion (B/A)	26%	(6,168-100) 74%	(8,100+100) 100%

**Answer 3**

(i) Loss for the year ended, 31st March, 2018

	(₹ in lakhs)
Amount of foreseeable loss	
Total cost of construction (6,250 + 1,250 + 8,750)	16,250
Less: Total contract price	(12,000)
Total foreseeable loss to be recognised as expense	4,250

According to AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Loss for the year ended, 31st March, 2018 amounting ₹ 4,250 will be recognized.

(ii) Contract work-in-progress as on 31.3.18

	(₹ in lakhs)
Contract work-in-progress i.e. cost incurred to date are ₹ 7,500 lakhs:	
Work certified	6,250
Work not certified	1,250
	7,500

(iii) Proportion of total contract value recognised as revenue

Cost incurred till 31.3.18 is 46.15% ( $7,500/16,250 \times 100$ ) of total costs of construction.

Proportion of total contract value recognised as revenue: 46.15% of ₹ 12,000 lakhs

= ₹ 5,538 lakhs

(iv) Amount due from/to customers at year end

(Contract costs + Recognised profits – Recognised Losses) – (Progress payments received + Progress payments to be received)

= (7,500 + Nil – 4,250) – (5,500 + 1,500) ₹ in lakhs

= [3,250 – 7,000] ₹ in lakhs

Amount due to customers = ₹ 3,750 lakhs

## AS 9 - REVENUE RECOGNITION

### 1. WHY AS 9?

It is basically concerned with the "timing of recognition" in the statement of Profit and Loss. It lays down criteria for recognition of revenue most suited to preparers of FS of enterprises engaged in varied activities.

### 2. WHAT IS REVENUE?

Revenue means the gross inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise from sale of goods, from the rendering of services and from the use by others of the resources of the enterprise yielding interest, royalties and dividend.

### 3. COMMON ELEMENTS FOR RECOGNITION OF REVENUE:

To all these three groups aforesaid, there are two common elements. It is imperative to seek answers to two questions.

- No significant uncertainty exists regarding the amount of the consideration that will be derived (MEASURABILITY)
- Are we certain that the amount will be received? (COLLECTABILITY)

#### NOTE:

(a) If Consideration is not measurable

Consideration receivable for sale of goods or for rendering of services should be determinable. When such consideration is not determinable within reasonable limits, revenue recognition will be postponed.

(b) If collectability is uncertain

When there is uncertainty about the collection of revenue even at the time when claim is raised recognition must be postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognize 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 recognized at the time of sale or rendering of service even though payments are made by installments.

(c) Effect of postponement

When recognition of revenue is postponed due to the effect of uncertainties, the amount is considered as revenue of the period in which it is properly recognized.

(d) Uncertainty arises later - make a provision (Do not adjust revenue)

When a transaction was concluded initially, the collectability was certain. Revenue, therefore, stood recognized. Subsequent to sale or rendering of the service, and at a much later date, the collectability of consideration is rendered uncertain. In such a situation, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

**4. SALE OF GOODS:**

Revenue is to be recognized when the following conditions are satisfied:

- (a) The seller has transferred to the buyer the property in goods for a consideration,  
OR
- (b) Significant risks and rewards of ownership have been transferred to the buyer AND
- (c) No significant uncertainty exists regarding the amount of consideration that will be derived from the sale of goods.

**5. RENDERING OF SERVICES :**

The Standard prescribes two methods:

**(a) COMPLETED SERVICE CONTRACT METHOD:**

Performance in a service contract may consist of

- (i) one single act
- (ii) or more than one act, where services not performed are significant enough in relation to all transaction taken as whole. Under such conditions, performance is not deemed complete and service is not chargeable unless all the transactions are completed.

Revenue is recognized only when the SOLE or FINAL act takes place and the service becomes chargeable.

**(b) PROPORTIONATE COMPLETION METHOD:**

This method evolved out of accrual concept - is to be applied when performance consists of execution of more than one act. Revenue is to be recognized proportionately by reference to the performance of each act.

Revenue is recognized when EACH independent act takes place and the proportionate service becomes chargeable.

**6. OTHER INCOME:**

**(a) INTEREST:**

Revenue must be recognized on time proportion basis.

**(b) ROYALTIES:**

Revenue is recognized on accrual basis in accordance with the terms of relevant agreement.

**(c) DIVIDENDS:**

Revenue is to be recognized only when the owner's right to receive payment is established (When dividends are DECLARED)

**EXCEPTION:** When interest, royalties and dividends are receivable from other countries which requires forex permission, revenue recognition has to be on CASH BASIS.

CLASSWORK QUESTIONS

**Question 1**

X Limited has recognized ₹ 10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of ₹ 50 lakhs held by it as at the end of the financial year 31st March, 2003. The dividends on mutual funds were declared at the rate of 20% on 15th April, 2003. The dividend was proposed on 10th March, 2003 by the mutual funds. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.

**Question 2**

The Board of Directors of X Ltd. decided on 31.3.2007 to increase sale price of certain items of goods sold retrospectively from 1st January, 2007. As a result of this decision the company has to receive ₹ 5 lakhs from its customers in respect of sales made from 1.1.2007 to 31.3.2007. But the Company's Accountant was reluctant to make-up his mind. You are asked to offer your suggestion.

**Question 3**

A Ltd. entered into a contract with B Ltd. to dispatch goods valuing ₹ 25,000 every month for 4 months upon receipt of entire payment. B Ltd. accordingly made the payment of ₹ 1,00,000 and A Ltd. started dispatching goods. In third month, due to a natural calamity, B Ltd. requested A Ltd. not to dispatch goods until further notice though A Ltd. is holding the remaining goods worth ₹ 50,000 ready for dispatch. A Ltd. accounted ₹ 50,000 as sales and transferred the balance to advance received against sales. Comment upon the treatment of balance amount with reference to the provisions of accounting standard 9.

CLASSWORK SOLUTIONS

**Answer 1**

Paragraph 8.4 and 13 of Accounting Standard 9 on Revenue Recognition states that dividends from investments in shares are not recognised in the statement of profit and loss until a right to receive payment is established.

In the given case, the dividend is proposed on 10th March, 2003, while it is declared on 15th April, 2003. Hence, the right to receive payment is established on 15th April, 2003. As per the above mentioned paragraphs, income from dividend on units of mutual funds should be recognised by X Ltd. in the financial year ended 31st March, 2004. The recognition of ₹ 10 lakhs on accrual basis in the financial year 2002-2003 is not as per AS 9 'Revenue Recognition'.

**Answer 2**

As per para 10 of AS 9 'Revenue Recognition', the additional revenue on account of increase in sales price with retrospective effect, as decided by Board of Directors of X Ltd., of ₹ 5 lakhs to be recognised as income for financial year 2006-07, only if the company is able to assess the ultimate collection with reasonable certainty. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

**Answer 3**

According to AS- 9, In case of sale of goods, the physical delivery of goods is not important for revenue recognition. What is relevant is transfer of significant risk & reward. Where delivery is delayed at buyer's request and buyer takes title and accepts billing. Revenue should be recognized notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognized rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

Here in this case on the request of B Ltd., goods worth ₹ 50,000 ready for dispatch but are held with A Ltd. until further notice is received from B Ltd. for its delivery.

Therefore A Ltd. will recognize ₹ 50,000 as its revenue for that period.

## AS 10 - PROPERTY, PLANT & EQUIPMENT

### 1. MEANING :

The Property, Plant and Equipment known as Fixed asset (Tangible Assets)

These tangible assets are assets held with the intention of being used for the purpose of producing or providing goods or services and are not held for sale in the normal course of business.

**Eg:** Land, Building, Plant and Machinery, Furniture and fixtures, office equipments etc.

### 2. AS 10 DOES NOT APPLY :

- Biological assets
  - Living animals
  - Living Plants (Does not include bearer plants)
- Wasting assets
- Asset Covered by another AS

**Note:** AS is applicable on bearer plants.

### 3. AT WHAT VALUE SHOULD ANY ASSET BE SHOWN IN BALANCE SHEET ?

- Historic Cost
- Revalued Price

- **Historic Cost**

Cost Under different circumstances

- **Purchased**

Cost of an item of fixed asset comprises of its purchase price, including non refundable taxes, any directly attributable cost and PV of decommissioning.

- **Self generated fixed asset**

Include all directly attributable cost (exclude any internal profits)

- **Exchange**

FMV of asset that goes out, if it is more evident otherwise FMV of asset that comes in record.

- **Free**

Record @ Nominal Value

- **Cost of jointly held assets**

Prorata cost of such jointly owned asset is grouped together with similar fully owned assets.

- **Cost of assets acquired under consolidated basis**

Cost of each fixed asset @ FMV By component valuation officer.

- **Revalued Price**

- 1st time upward revaluation –RR
- 1st time downward revaluation- P/L
- Present increase is credited to RR if previous revaluation also led to increase
- Present increase is relatable to previous decrease the credit revenue to the extent of previous decrease and remaining increase in RR
- Present decrease is charged to P/L if previous revaluation also led to decrease
- If present decrease is relatable to previous increase then change RR to intent of previous increase & remaining in P/L

**Note:** Revaluation should be performed for an ENTIRE CLASS of PPE

#### 4. COMPONENT ACCOUNTING :

- An asset may consist of several different and significant physical components.
- If an item of PPE may consist two or More Significant components with substantially different useful life or usage then each component must be recorded and depreciated SEPARATELY

**Note:** When a significant component is replaced, the old component is de-recognized.

#### 5. SUBSEQUENT EXPENDITURE :

- It is the expenditure, which is incurred after the initial recognition i.e. after the asset is ready to use or being used. Here, we discuss whether subsequent expenditure will go to P&L or will be capitalized along with PPE. It depends on the nature and benefits from the expenditure incurred.

Does the subsequent expenditure increases future economic benefits i.e satisfies the recognition criteria?

YES

NO

Capitalise along with PPE

Charge to P&L statement

- If subsequent expenditure increases the future economic benefits i.e. satisfies recognition criteria then such expense is recognized as a separate component and depreciated over its useful life.
- Costs of day to day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of such expenditures is often described as for the “repairs and maintenance” of item of PPE and these expenses should be charged to Profit and loss Account.
- If a part of PPE is replaced then it should be capitalized as Component of PPE if it meets recognition criteria given by AS, otherwise, it will be charged to P&L statement.
- A condition of continuing to operate an item of PPE may be performed in regular intervals as major inspection for faults regardless of whether parts of PPE are replaced. When each such major inspections are performed, its cost is capitalized as part of PPE as a replacement if the recognition criteria is satisfied.

#### 6. DEPRECIATION :

- Depreciable amount= Cost-SV
- It is systematic allocation of depreciable amount of an asset over its useful life
- Determinants-Cost-SV-Life-Future Economic benefits
- Methods- SLM, WDV, on basis of future economic benefits
- Changes in methods/ determinant – Change in Accounting estimate, effect prospective as per AS 5

#### 7. RETIREMENT :

Value @ Net Book Value

Or

Net realizable value, whichever is lower

#### 8. DISPOSAL :

- If Entity followed cost model then profit or loss on sale will go to profit or loss account.
- If entity followed revaluation model then profit or loss on sale will go to P/L a/c (after disposal Revaluation reserve will be transferred to general reserve)

**9. DISCLOSURE :**

- Depreciation method
- Depreciation rate
- Life of PPE
- Measurement basis (cost model or revaluation method)
- **Cost model**
  - In balance sheet show: Gross BV – Accumulated depreciation - Accumulated Impairment loss = Net BV
- **Revaluation Model**
  - In balance sheet show: Gross BV – SUBSEQUENT accumulated depreciation – SUBSEQUENT accumulated impairment loss = Net BV
- **Reconciliation between :**
  - Addition
  - Retirement
  - Disposal
  - Acquisition
  - Revaluation
  - Depreciation
  - Impairment loss
- Contractual commitment for acquisition of PPE
- Existence and restriction on title and PPE pledged as securities
- If the asset is revalued
  - Date of revaluation
  - Valuer is independent or not
  - Methods and assumption of revaluation
  - Revaluation surplus, if any

CLASSWORK QUESTIONS

**Question 1**

Aman Ltd. Contracted with a supplier to purchase a specific machinery to be installed in Department A in two months time. Special foundations were required for the plant, which were to be prepared within this supply lead time. The cost of site preparation and laying foundations were ₹ 47,290. These activities were supervised by a technician during the entire period who is employed for this purpose of ₹ 15,000 per month. The technician's services were given to department A by department B, which billed the services at ₹ 16,500 per month after adding 10% profit margin. The machine was purchased at ₹ 52,78,000. Sales Tax was charged at 4% on the invoice, ₹ 18,590 transportation charges were incurred to bring the machine to the factory. An architect was engaged at a fee of ₹ 10,000 to supervise machinery installation at the factory premises. Also, payment under the invoice was due in 3 months. However, the company made the payment in 2nd month. The company operates on Bank Overdraft @11%. Ascertain the amount at which the assets should be capitalized under AS 10.

**Question 2**

M/s. Tiger Ltd. allotted 7,500 equity shares of ₹ 100 each fully paid up to Lion Ltd. in consideration for supply of a special machinery. The shares exchanged for machinery are quoted at National Stock Exchange (NSE) at ₹ 95 per share, at the time of transaction. In the absence of fair market value of the machinery acquired, show how the value of the machinery would be recorded in the books of Tiger Ltd.?

**Question 3**

B Ltd. owns an asset with an original cost of '2,00,000'. On acquisition, management determined that the useful life was 10 years and the residual value would be '20,000'. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value. At the end of year 8, management has reviewed the useful life and residual value and has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by company. As a result, the residual value will reduce to ₹ 10,000. How would the above changes in estimates be made by B Ltd.?

CLASSWORK SOLUTIONS

**Answer 1**

Calculation of Cost of Machinery to be Capitalised.

Particulars	₹
Purchase Price	52,78,000
(+) 4% Sales tax	2,11,120
(+) Cost of site preparation & Laying foundations	47,290
(+) Supervisors Salary (15000 p.m. × 2m)	30,000
(+) Transport Charges	18,590
(+) Architect's fees	10,000
<b>Cost of Machinery</b>	<b>55,95,000</b>

**Notes:**

- (1) If it is assumed that 4% sales tax is not included in the purchase price, it is not refundable.
- (2) Internal profits w.r.t. supervisors salary shall be eliminated.
- (3) Interest on O.D. shall not form the cost of machinery.

**Answer 2**

As per AS 10 "Property, Plant & Equipment", fixed asset acquired in exchange for shares or other securities in the enterprise should be recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident. Since, in the given situation, the market value of shares exchanged for the asset is more clearly evident, the company should record the value of machinery at ₹ 7,12,500 (i.e. 7,500 shares × ₹ 95 per share) being the market price of the shares issued in exchange.

**Answer 3**

As per AS 10 property plant and equipment, Change in useful economic life of an asset & residual value is change in accounting estimate, which is to be applied prospectively, i.e. the depreciation charge will need to be recalculated.

At the end of the 8th year the asset's net book value is ₹ 56,000 (2,00,000 – 1,44,000). The company should amend the annual provision for depreciation to charge the unamortised cost (namely ₹56,000) over the revised remaining life of four years. Consequently, it should charge depreciation for the next four years at ₹ 11,500 per annum.

$$\text{Depreciation for 8 yrs.} = \frac{2,00,000 - 20,000}{10} = 18,000 \times 8 = ₹ 144,000$$

$$\text{Depreciation for Last 4 yrs} = \frac{56,000 - 10,000}{10} = ₹ 11,500 \text{ p.a.}$$

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## AS 11 - ACCOUNTING FOR EFFECTS FOR CHANGES IN FOREIGN EXCHANGE RATES

### 1. SCOPE :

AS 11 applies to the following:

- (a) Accounting for transactions in foreign currency.
- (b) Translating the financial statements of foreign operations for inclusion in Company's financial statements.
- (c) Accounting for foreign currency transactions in the nature of forward exchange contracts.

### 2. DEFINITIONS :

- (a) **Reporting Currency:** Currency used in presenting financial statements.
- (b) **Foreign Currency:** Currency other than reporting currency of an enterprise.
- (c) **Exchange Rate:** It is the ratio for exchange of 2 currencies.
- (d) **Average Rate :** It is the mean of the exchange rates in force during a period
- (e) **Forward Rate:** It is the agreed exchange rate for exchange of 2 currencies at a specified future date.
- (f) **Forward Exchange Contract:** It is an agreement to exchange different currencies at a forward rate.
- (g) **Closing Rate:** It is the Exchange Rate at the Balance Sheet date.
- (h) **Monetary items:** They are money held & assets & liabilities to be received or paid in fixed or determinable amounts of money. E.g.: Cash, Bank balance, Receivables, Payables etc.
- (i) **Non-monetary items:** They are assets & liabilities other than monetary items. E.g.: FAs, Inventories, Investment in equity shares etc.
- (j) **Settlement date:** Date on which a receivable is due to be collected / a payable is due to be paid.
- (k) **Foreign Operation:** A Subsidiary, Associate, JV or Branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise. Under AS 11, a foreign operation is classified as either 'Integral Foreign Operation' or 'Non-Integral Foreign Operation', based on the way of financing & operation in relation to the reporting enterprise.

- (l) **Integral Foreign Operation (IFO)** : Its activities are an integral part of those of the reporting enterprise, its business is carried on as if it was an extension of the reporting enterprise's operations, IFOs generally carry on business in a single foreign currency of the country where it is located, cash flows from operations of the reporting enterprise are directly & immediately affected by a change in the exchange rate between the reporting currency & currency of the IFOs country, change in exchange rate affect individual monetary items held by the IFO rather than the reporting enterprise's investment in IFO etc.
- (m) **Non-Integral Foreign Operation (NFO)** : It is a foreign operation that is not an IFO. The business of NFO is carried on in a substantially independent manner in its local currency, NFOs may also enter into business transactions in foreign currencies, including transactions in reporting currency, change in the exchange rate between the reporting currency & local currency has little or no direct effect on the present or future cash flows from operations of the NFO or the reporting enterprise, change in the exchange rate affects the reporting enterprise's net investment in the NFO rather than the individual monetary / non-monetary items held by that NFO.

### 3. FOREIGN CURRENCY TRANSACTIONS :

(a) **Initial Recognition**

Transactions involving foreign currencies can be brought under four groups, namely (a) buying or selling of goods and services, (b) borrowing or lending money, (c) acquiring or disposing of assets or incurring and settling liabilities, or (d) by being a party to a forward exchange contract. For initial recognition, the Accounting Standards prescribe that a foreign currency transaction should be **recorded** by applying the **exchange rate** (defined as ratio for exchange for two currencies) between the reporting currency and the foreign currency at the date of the transaction.

(b) **Reporting at subsequent Balance Sheet date**

For purposes of reporting as at the balance sheet date, items are classified into monetary and non-monetary items, which are carried at either historical cost, or at fair values.

**Monetary items** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. Examples are cash balances, account receivables and payables. **Non-monetary items** are assets and liabilities

other than monetary items. Examples include fixed assets, inventories, and investments in equity shares.

Accounting standards lays down the following principles for translation of foreign currency items.

1. Apply **closing rate** for monetary items  
Monetary items in the balance sheet should be reported using the closing rate.
2. Apply **Transaction-date** rate or the rate that existed on **fair-value estimation date** for non-monetary items.

**(c) Recognizing exchange difference**

Exchange difference has been defined in Accounting standards as the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Exchange differences can arise, inter alia, on three counts

- A transaction – either a monetary item, or a non-monetary item – being settled at a rate of different from the rate at which it was initially recorded (initial recognition)
- A transaction being reported at a rate different from the rate at which it was initially recorded (balance sheet reporting)
- A transaction being settled at a rate different from the one taken for reporting in the last financial statement (settlement).

**4. TRANSLATION OF FINANCIAL STATEMENT OF FOREIGN OPERATIONS**

- Foreign operation is a **subsidiary, associate, joint venture or branch** of the reporting enterprise, the activities of which are based on or conducted in a foreign country.
- It is not necessary that the subsidiary, associate joint venture or branch should be based in foreign country. Its activities must be based or conducted in a foreign country.
- Foreign operation is classified into -
  - (a) Integral foreign operation and
  - (b) Non-integral foreign operation.

**Financial statement of IFO**

Accounting standards requires the financial statement to be translated in the same manner as applicable for the enterprises own foreign currency transaction, i.e.

- (a) All transactions of foreign operation be translated at the rate prevailing on the date of transaction (spot rate).
- (b) Translation at balance sheet date
  - (i) Monetary items at closing rate;
  - (ii) Non-monetary items which are carried at historical cost at the rate at the date of transaction and
  - (iii) Non-monetary items which are carried at fair value like net realizable value at the rate of such date of ascertaining fair valuation.

**Note:** Accounting standards does not state about conversion of revenue items of such organization because it will automatically get converted at spot rate as per (a) above.

#### Recognition of Foreign Exchange difference-

Exchange difference arising on reinstatement/settlement of monetary items be recognized in P & L.

#### Financial Statements of Non-integral Foreign Operation

For incorporating in its financial statement the financial statements of a non-integral foreign operation should be translated in the following manner.

- (a) All assets and liabilities monetary as well as non-monetary, translated at closing rate.
- (b) Income and expenses items be translated at the rate of the date of transaction. (Average rate of the period if it approximates the actual rate can be used)

#### Recognition of exchange difference -

- All exchange difference be accumulated and carried in foreign currency translation reserve.
- When the net investment in such non-integral operation in full or in part is disposed of then this reserve will be proportionately recognized to P&L.
- Such reserve can have debit balance as well.

### 5. FORWARD EXCHANGE CONTRACT :

#### ➤ When forward contract is for hedging

- (a) The premium or discount (difference between the value at spot rate and forward rate) should be amortized over the life of contract.

- (b) Exchange difference (difference between the value of settlement date / reporting date and value at previous reporting date / inception of the contract) be recognized in P & L of the year.
- (c) Profit / loss on cancellation / renewal of forward contract be recognized in P & L of the year.

➤ **When forward contract is for Trading / Speculation**

- (a) No premium or discount is recognized.
- (b) A gain or loss i.e. the difference between the forward rate as per contract/ previous year end valuation rate and the forward rate available at the year end (reporting date) for remaining maturity period should be recognized in the P&L of the period.

**6. DISCLOSURES :**

An enterprise should disclose :

- (a) The amount of exchange differences included in the net profit / loss for the period &
- (b) Net exchange difference accumulated in FCTR as a separate component of shareholders' funds & a reconciliation of the amount of such exchange differences at the beginning & end of the period.

**CLASSWORK QUESTIONS**

**Question 1**

DBK Industries Ltd. invoiced goods to West Germany worth US \$ 1,00,000 on 10th March, 2005 on which date exchange rate for US \$ 1 was ₹ 41.00.

The payment for the same was received as under :-

Date of Receipt	Received	Exchange rate for US \$ 1
20-03-2005	US \$ 40,000	₹ 42.00
29-03-2005	US \$ 35,000	₹ 41.00
15-04-2005	US \$ 25,000	₹ 44.00

The company closes its accounting year on 31st March. The exchange rate as on 31-03-2005 was 1 US \$ ₹ 45.00. Pass Journal entries of the same.

**Question 2**

(i) Jared Limited purchased a Machine for US \$20,000 on 31st December, 2021 Payable after four months. It entered into a forward contract for four months @ ₹ 78.85 per US \$. On 31st December, 2021 the exchange rate was ₹ 77.50 per US \$.

How will you recognize the Profit or Loss on Forward Contract for the year ended 31st March, 2022 in the books of Jared Limited?

(ii) Trade Payables of Jared Limited includes amount due to Sterling Limited ₹ 9,75,000 recorded at the prevailing exchange rate on the date of purchase; transaction recorded at US \$ 1 = ₹ 75.00.

The exchange rate on Balance Sheet date (31st March, 2022) was US \$ 1 = ₹ 79.00.

The payment was made on 1st May, 2022 when the exchange rate was US \$ 1 = ₹ 78.30.

You are required to calculate the amount of exchange difference on 31st March, 2022 and 1st May, 2022 and also explain the accounting treatment needed in the above case as AS 11 in the books of Jared Limited.

(Nov'22 - 5 Marks)

CLASSWORK SOLUTIONS

Answer 1

In the Books of DBK Industries Ltd

Journal

2004-05				
10.03	West Germany A/c To sales A/c (US \$ 1,00,000 x ₹ 41) (Being Sold Goods of US \$ 100,000 at exchange rate of 1\$ = ₹41)	Dr.	41,00,000	41,00,000
20.03	Bank A/c (\$ 40,000 x ₹42) To West Germany A/c (\$ 40,000 x ₹41) To Foreign Exchange Difference (\$ 40,000 x ₹1) (Being part payment received from Debtors & exchange gain realized.)	Dr.	16,80,000	16,40,000 40,000
29.03	Bank A/c To west Germany A/c (\$ 35,000 x ₹41) (Being part payment received & No exchange gain or loss)	Dr.	14,35,000	14,35,000
31.03	West Germany A/c To Foreign Exchange difference A/c (\$ 25,000 x ₹4) (Being Debtor translated at the closing rated & exchange gain recognised)	Dr.	1,00,000	1,00,000
31.03	Foreign Exchange Difference A/c To Profit & loss A/c (Being foreign exchange Difference gain transferred to profit & loss A/c)	Dr.	1,40,000	1,40,000
2005-06				
15.04	Bank A/c (\$ 25,000 x ₹44) Foreign Exchange Difference A/c (\$ 25,000 x ₹1) To West Germany A/c (Being Debtor settled & foreign) exchange Difference loss recored	Dr.	11,00,000 25,000	11,25,000

**Answer 2**

		₹	
(i)	Forward Rate		78.85
	Less: Spot Rate		(77.50)
	Premium on Contract		1.35
	Contract Amount		US\$ 20,000
	Total Loss (20,000 × 1.35)		₹27,000

Contract period 4 months (3 months falling in the year ended 31st March, 2022)  
Loss to be recognized (₹27,000 × 3/4) = ₹20,250 in the year ended 31st March, 2022.

- (ii) As per AS 11 “The Effect of Changes in Foreign Exchange Rates”, exchange differences arising on the settlement of monetary items or on reporting an enterprise’s monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or as expenses in the period in which they arise.

Trade payables	Foreign Currency Rate	Amount ₹
Initial recognition US \$13,000 (9,75,000/75)	1 US \$ = ₹75	
Exchange Rate on Balance sheet date	1 US \$ = ₹79	
Exchange Difference Loss US \$13,000 × (79 - 75)		52,000
Exchange Rate on Settlement date	1 US \$ = ₹78.30	
Exchange Difference Profit US \$13,000 × (79 - 78.30)		9,100

For the year ended 31st March, 2022 exchange difference loss amounting ₹52,000 will be charged to statement of Profit & Loss A/c.

However, there is exchange difference gain of ₹13,000 × (79 - 78.30) = 9,100 on 1st May, 2022. Thus gain of ₹9,100 will be credited to statement of Profit & Loss A/c for the year ended 31st March, 2023.

## AS 12 - ACCOUNTING FOR GOVERNMENT GRANTS

### 1. GOVERNMENT:

Government refers to

- government,
- government agencies and
- similar bodies whether local (like Municipal Corporation), national or international (e.g. World Bank, Asian Development Bank).

### 2. GOVERNMENT GRANTS:

Government grants are –

- assistance by government
- in cash or kind to an enterprise
- for past or future compliance with certain conditions.

#### The term Government grant excludes

- those forms of government assistance which cannot reasonably have a value placed upon them and
- transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.
- Equity Investment by Government
- Tax Holidays

3. Accounting for Government grants :

Nature of Grant	Description of the grant	At the time of initial recognition - debit to bank/receivable account and .....	If required to be refunded - credit to bank / payable account and ....
1. Related to specific fixed assets (depreciable fixed assets) (This can also be intangible assets covered under AS- 26)	Grant related to specific fixed assets are government grants whose primary condition is that an enterprise should purchase, construct or otherwise acquire such assets.	a. Credit to that fixed asset A/c (charge depreciation on the reduced value) or b. Credit to govt. grant A/c (show in balance sheet in reserves) (w/ off it to P & L A/c over the life of assets in proportion to depreciation)	Debit to that fixed asset A/c (charge depreciation on revised value prospectively) Debit to govt. grant A/c (to the extent of bal.) Debit to P & L a/c (excess if any)
2. Related to Non-depreciable fixed asset	Same as above.	(a) Credit to that fixed asset or	Debit to that fixed asset a/c
		(b) Credit to capital reserve A/c or	Debit to capital reserve a/c (to the extent of bal.) Debit to P & L a/c (excess if any)
		(c) But if it has certain cost then defer it & credit to P & L A/c. in the period in which such cost is being incurred.	Debit to capital reserve a/c (to the extent of bal.) Debit to P & L a/c (excess if any)

<p>3. In the nature of promoters contribution</p>	<p>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.</p>	<p>Credit to capital reserve A/c</p>	<p>Debit to deferred credit a/c (to the extent of bal.) Debit to P &amp; L a/c (excess if any)</p>
<p>4. Grants related to revenue</p>	<p>Grants intended to compensate expenses incurred in the past or to be incurred in the future.</p>	<p>(a) Credit to P &amp; L a/c as other income or reduce it from related expenditure. Or</p>	<p>Debit to P &amp; L a/c.</p>
		<p>(b) Credit to deferred credit (w/off to P &amp; L in the period over which related cost are incurred)</p>	<p>Debit to deferred credit A/c (to the extent of balance) Debit to P &amp; L a/c (excess if any)</p>

5.	In lieu of past period cost or with no corresponding cost to be incurred	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.	Credit to P & L A/c (as extraordinary item)	Debit to P & L a/c.
6.	Non-monetary grant	Grant in kind		In case of default to comply with the terms and conditions of govt. grant (AS is silent on this point). Following can be the possibilities.
(a)	Asset given at concessional rate		Account at the actual cost incurred i.e., at concessional rate debiting asset and crediting bank A/c.	If asset is taken over-write off the book value to P & L a/c.
(b)	Given free of cost		Account at token value say ₹ 1 or ₹ 100 debiting the asset A/c and crediting P & L A/c	If the concession amount is required to be paid then debit the asset a/c. and credit the bank A/c. depreciate this revised value prospectively.

**4. DISCLOSURE :**

The following should be disclosed:

- (i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;
- (ii) the nature and extent of government grants recognised in financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

CLASSWORK QUESTIONS

**Question 1**

Explain the treatment of the following:

- (a) a firm acquired a fixed asset for ₹ 250 lakhs on which the government grant received was 40%
- (b) Capital Subsidy received (As Promoters contribution) from the central government for setting up a plant in the notified backward region. Cost of the plant ₹ 300 lakhs. Subsidy received ₹ 100 lakhs.
- (c) ₹ 50 lakhs received from the state government for the setting up of water treatment plant.
- (d) ₹ 25 lakhs received from the local authority for providing medical facilities to the employees.

**Question 2**

Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for ₹ 10 lakhs. Pass the necessary journal entries in the books of the company for first two years on the assumption that Grant is credited to Defers Grant A/c.

**Question 3**

A Ltd. purchased a machinery for ₹40 lakhs. (Useful life 4 years and residual value ₹ 8 lakhs) Government grant received is ₹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.

CLASSWORK SOLUTIONS

**Answer 1**

- (a) Receipt of grant of ₹100 lakhs can be credited to Depreciable Fixed Asset Account so as to reduce its cost. Alternatively ₹100 lakhs can be credited to Deferred Government Grant Account & amortised over useful life of Fixed Asset in proportion of Depreciation.
- (b) The grant received is in the nature of capital subsidy (AS Promoters contribution) and hence to be credited to Capital Reserve A/c.  
The Plant should appear at ₹300 lakhs.
- (c) The grant received from state government should be deducted from the cost of the asset.  
Alternatively it can be credited to Deferred Government Grant Account & amortised over useful life of Plant in proportion of Depreciation.
- (d) ₹ 25 lacs received from local authority for providing medical facilities to the employees is to be credited to Profit & Loss A/c.

**Answer 2**

As per AS-12 “Accounting for Govt grant”, grant refundable w.r.t to a depreciable fixed asset should be added back to the Book value of the asset if it was deducted at the time of receipt. After Adding up the amount of refund, the B.V. & amount of Depreciation to be charged will change.

In this case, the fund of Grant of ₹300 Lakhs will be added back to the Book value of Asset as it was earlier deducted at the time of receipt

BV before Refund = ₹ 1,500 Lakhs – ₹ 300 Lakhs

= ₹ 1,200 Lakhs (-) 20% per annum Depreciation for 3 years on WDV basis

= ₹ 614.4 Lakhs

∴ Revised BV after refund of grants = ₹ 614.4 Lakhs + ₹ 300 Lakhs

= ₹ 914.40 Lakhs

Depreciation will be charged @ 20% WDV on the Revised Book value.

**Note:**

In absence for information we have assumed that grant is refunded at the beginning of May 2004 and we have ignored the depreciation for the month of April 2004. Alternative answer considering otherwise also possible.

**Answer 3**

(a) In the books of Ram Ltd.

(1) If the grants is credited to Fixed Assets Account:

1. Journal Entry (at the time of refund of grant)

			In lakhs ₹	In lakhs ₹
I	Fixed Assets	Dr.	16	
	To Bank A/c			16
	(Being grant refunded)			

2. Value of Fixed Assets after two years but before refund of grant

Fixed assets initially recorded in the books

= ₹40 lakhs - ₹16 lakhs

= ₹24 lakhs

Depreciation p.a. = (₹24 lakhs - ₹ 8 lakhs)/4 years

= ₹ 4 lakhs per year for first two years.

Value of the assets before refund of grant = ₹ 24 lakhs - ₹ 8 lakhs

= ₹ 16 lakhs.

3. Value of Fixed Assets after refund grant

Value of Fixed Assets after refund of grant

₹16 lakhs

Add Refund of grant

₹ 16 lakhs

₹ 32 lakhs

4. Amount of depreciation for remaining two years

Value of the fixed assets refund of grant – residual value of the assts/ No. of years

= ₹ 32 lakhs - ₹ 8 lakhs/2

= ₹ 12 lakhs per annum will be charged for next two years.

(2) If the grant is credited to Deferred Grant Account:

As per 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 asset is charged.

Accordingly, in the first two years (₹16 lakhs/4 years) = ₹4 lakhs p.a. x 2 years

= ₹ 8 lakhs will be credited to Profit and Loss Account and ₹ 16 lakhs will be the

balance of Deferred Grant Account after two years.

Therefore, on refund of grant, following entry will be passed:

			₹	₹
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)			

- Value of Fixed Assets after two years but before refund of grant  
Fixed asset initially recorded in the books = ₹40 lakhs  
Depreciation p.a. =  $(₹40 \text{ lakhs} - ₹ 8 \text{ lakhs})/4 \text{ years} = ₹ 8 \text{ lakhs per year}$   
Book value of fixed assets after two years =  $₹40 \text{ lakhs} - (₹8 \text{ lakhs} \times 2 \text{ years})$   
= ₹ 24 lakhs
  - Value of Fixed Assets after refunded of grant  
On refund of grant the balance of deferred grant account will become nil. The Fixed assets will continue to be shown in the books at ₹ 24 lakhs.
  - Amount of depreciation of remaining two years  
Depreciation will continue to be charged at 8 lakhs per annum for the remaining two years.
- Note:** In absence for information we have assumed that grant is refunded at the beginning of 3rd year

## AS 13 - ACCOUNTING FOR INVESTMENT

### 1. WHAT ARE INVESTMENTS?

Investments are:

- Assets
- Held by an enterprise for earning incomes by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise.

Assets held as stock in trade are not 'investments'.

Some investments have no physical existence and are represented merely by certificates or similar documents while others exist in physical form.

### 2. DETERMINATION OF COST:

- If investments are purchased:  
The cost of an investment includes acquisition charges such as brokerage, fees and duties. Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. In such case, it should be deducted from the cost.
- If investments are acquired for consideration other than cash:

Sr. no.	Consideration in the form of	Valued at
1.	Shares or securities	Fair value of securities issued
2.	Other assets	Fair value of asset given up or Fair value of asset acquired whichever is known more appropriately.

- **Cost of right shares:**
  - When right shares offered are subscribed for, the cost of right shares is added to the carrying amount of the original holding.
  - If the right shares are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement.

- However, where the investments are acquired on cum 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 right to reduce the carrying amount of such investments to the market value.

### 3. DETERMINATION OF FAIR VALUE:

Fair value is the amount for which an asset could be exchanged between a knowledge-able, willing buyer and a knowledgeable, willing seller in an arms' length transaction.

### 4. DETERMINATION OF CARRYING AMOUNT OF INVESTMENTS (VALUATION):

- **Current investments:**

Current Investments should be carried in the financial statement at lower of cost or fair value. The lower of cost or fair value should not be determined on overall basis. It should be determined-

- (a) On an individual investment basis (More prudent) or
- (b) By category of investment.

Any reduction to fair value of current investments or any reversal of such reduction should be included in profit or loss account.

- **Long term Investments:**

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.

Such reduction should be determined and made for each long term investments individually.

### 4. DISPOSAL:

On disposal of an investment, the difference between the carrying amount and disposal proceeds, net of expenses, is recognized in profit or loss account. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment (i.e. weighted average cost)

## 5. RECLASSIFICATION OF INVESTMENTS:

From long term investment to current investment.

Transfers are made at the lower of cost and carrying amount on the date of transfer

From current investment to long term investment.

Transfers are made at the lower of cost and fair value on date of transfer.

## 6. DISCLOSURE:

- The accounting policies for determination of carrying amount of investments.
- An Enterprise should disclose current Investments and long term investments separately.
- As per Schedule III of Companies Act, 2013 further classification should disclose investments in:
  - (a) Government securities
  - (b) Shares, Debentures or bonds
  - (c) Investment properties
  - (d) Others-Specifying nature.
- The amounts included in profit or loss statement for:
  - (a) Interest, dividends and rentals on investments showing separately such in- come from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes paid.
  - (b) Profit or loss on disposal of current investments and changes in the carrying amount of such investments.
  - (c) Profit or loss on disposal of Long term investments and changes in the carrying amount of such investments.
- Significant restrictions on the rights of ownership, realisability of investments or the remittance of income and proceeds of the disposal.

**CLASSWORK QUESTIONS**

**Question 1**

Albert Ltd. has made the following investments:

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

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

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

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

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

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

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

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

**Question 2**

Bharat Ltd. wants to re-classify its investments in accordance with AS 13. Decide on the amount of transfer, based on the following information:

(1) A portion of current investments purchased for ₹ 20 lakhs, to be re - classified as Long - term investments, as the company has decided to retain them. The market value as on the date of balance sheet was ₹ 25 lakhs.

(2) Another portion of current investments purchased for ₹ 15 lakhs, to be re- classified as long-term investments. The market value of these investments as on the date of balance sheet was ₹ 6.5 lakhs.

- (3) Certain Long-term investments no longer considered for holding purposes, to be re-classified as current investments. The original Cost of these were ₹ 18 lakhs but had been written down to ₹ 12 lakhs to recognize permanent decline as per AS 13.

**Question 3**

Sabka Bank has classified its total investment on 31-3-2017 into three categories (a) held to maturity (b) available for sale (c) held for trading. 'Held to maturity' investments are carried at acquisition cost less amortised amount. 'Available for sale' investments are carried at marked to market. 'Held for trading' investments are valued at weekly intervals at market rates or as per the prices declared by FIMMDA. Net depreciation, if any, is charged to revenue and net appreciation, if any, is ignored. Comment whether the policy of the bank is in accordance with AS 13?

CLASSWORK SOLUTIONS

**Answer 1**

1. As per As 13, “Accounting for Investment”, for investment in shares – if the investment is purchased with an intention to hold for short-term period then it will be shown at the lower of cost or realizable value of as on 31st March, 2011.

Scrip X ₹ 1,80,000 (cost)

Scrip Y ₹ 50,000 (cost)

Scrip Z ₹ 40,000 (NRV)

If equity shares are acquired with an intention to hold for long term period then it will continue to be shown at cost in the Balance Sheet of the company. However, provision for diminution shall be made to recognize a decline, if other than temporary, in the value of the investments.

2. As Per the standard, investment acquired for long term period shall be shown at cost. Gold is generally purchased with an intention to hold it for long term period until and unless given otherwise. Hence, the investment in Gold (Purchased on 1st April, 2007) shall continue to be shown at cost as on 31st March, 2011, i.e.

₹ 3,00,000 though their realizable values have been increased.

3. Investments in mutual funds are treated as long-term, then they will be valued at its cost ₹ 6.00.000 unless there is a permanent reduction in its value. However, provision for diminution shall be made to recognize a decline, if other than temporary, in the value of the investment.

4. Investment in Govt. securities, are treated as long-term, then they will be valued at its cost ₹ 5,00,000, though it's realizable value is greater than its cost.

It is not possible to set of diminution in investment in mutual funds against appreciation of the value of investment in government securities, as the gain is unrealized on govt. securities which will not be recorded in the books where as if the reduction in value of mutual fund is of permanent nature then the loss only will be recognized in the statement of Profit & Loss.

**Answer 2**

As per As 13, 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 investment is ₹ 25 lakhs, which is higher than its cost i.e. ₹ 20 lakhs. Therefore, the transfer to long term investments should be carried at cost i.e. ₹ 20 lakhs.

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

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

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

### Answer 3

As per para 2(d) of AS 13 'Accounting for Investments', the accounting standard is not applicable to Bank, Insurance Company, Mutual Funds. In this case Sabka Bank is a bank, therefore, AS 13 does not apply to it. For banks, the RBI has issued guidelines for classification and valuation of its investment and Sabka Bank should comply with those RBI Guidelines/Norms. Therefore, though Sabka Bank has not followed the provisions of AS 13, yet it would not be said as non-compliance since, it is complying with the norms stipulated by the RBI.

## AS 15 - EMPLOYEE BENEFITS

### EMPLOYEE BENEFITS

AS 15 deals with all kinds of employee benefits which include:

- (i) Short term employee benefits such as wages
- (ii) Post-Employment benefits such as gratuity
- (iii) Other Long-Term Employee Benefits such as sabbatical leave
- (iv) Termination benefits

AS 15 was issued by ICAI and came into effect with regards to accounting periods on or after April 1, 2006.

### APPLICABILITY OF AS 15

1. Accounting Standard 15 is applicable to the following enterprises at any time during the accounting period.
  - Enterprises having their equity or debt securities listed whether in India or outside India
  - The enterprises undergoing the process of getting their equity or debt listed
  - Banks including Cooperative Banks
  - Financial Institutions
  - Enterprises undertaking Insurance business
  - All enterprises including industrial, commercial and business reporting enterprises having an annual turnover of more than Rs 50 Crores in the preceding accounting period based on the audited financial statements
  - Enterprises including industrial, commercial and business reporting enterprises having borrowings including public deposits of more than Rs 10 Crores at any time during the accounting period.
  - Holding as well as subsidiary enterprises of any of the ones mentioned above at any time during the accounting period.
2. All the enterprises that do not form part of the ones mentioned above under point A and have 50 or more persons on an average employed during the year. There are however exceptions to such enterprises which can be referred to in AS 15 (Revised 2005).

3. Enterprises that do not form part of categories mentioned in point A above and have less than 50 persons on an average employed during the year. There are however exceptions to such enterprises which can be referred to in AS 15 (Revised 2005).

### EMPLOYEE BENEFITS

As per Accounting Standard 15, an employee is defined as a person rendering service to an enterprise on a full-time, part time, permanent, casual or temporary basis. For the purpose of AS 15, employees include whole time directors and other management personnel.

Furthermore, AS 15 deals with employee benefits which include:

1. Short-Term Employee Benefits. These include wages, salaries, social security contributions (such as contribution to an insurance company made by an employer in order to pay for the medical care of its employees), paid annual leave, profit-sharing and bonuses (if such bonuses are payable within 12 months of the end of the period) and non-monetary benefits (these include cars, housing, medical care and free/subsidized goods or services) for current employees.
2. Post-Employment Benefits. These include gratuity, pensions, other retirement benefits, post employment life insurance and post employment medical care.
3. Other Long-Term Employee Benefits. These include sabbatical leave, jubilee or other long-term service benefits, long-term disability benefits. Furthermore, if such benefits are not paid wholly within 12 months after the end of the period, then, profit-sharing, bonuses and deferred compensation would be paid.
4. Termination Benefits. That is benefits given to an employee when he leaves the organization.

### SHORT-TERM EMPLOYEE BENEFITS

As per AS 15, Short-Term employee benefits consist of:

- Wages, salaries and social security contributions
- Short-Term paid absences such as paid annual leave where such absences are expected to take place within 12 months after the end of the period during which the employees provide related employee service.
- Profit-Sharing and Bonuses payable within 12 months after the end of the period during which employees provide related services.
- Non-Monetary Benefits including medical care, housing, cars and free/subsidized goods or services for current employees.

## RECOGNITION AND MEASUREMENT

Whenever an employee provides service to an enterprise during an accounting period, the enterprise must identify the un-discounted amount of short-term employee benefits that are anticipated to be paid for that service.

Accordingly, such employee benefits are recognized as:

- (i) a liability after deducting any amount of employee benefit that has already been paid. Furthermore, if the amount of employee benefits paid is more than the un-discounted amount of benefits, the enterprise is required to identify such an excess as a prepaid expense. That is, as an asset. This prepayment should be identified as an asset in such a way that it results in reduction in future employee benefit payment or cash refund.
- (ii) as an expense till the time any other accounting standard permits benefits to be included in the cost of the asset.

## POST-EMPLOYMENT BENEFITS

As mentioned above, Post-Employment Benefits consist of:

- (i) Retirement Benefits – eg. pension and gratuity
- (ii) Other Benefits – e.g. post-employment life insurance and post-employment medical care

Now, such benefits are extended to the employees via arrangements known as post employment benefit plans.

Any enterprise applies accounting standard 15 to all such arrangements irrespective of the fact whether such arrangements involve establishment of a separate entity to receive contributions and pay benefits.

Furthermore, these post-employment benefit plans are classified into:

- (i) Defined Contribution Plans
- (ii) Defined Benefit Plans

Such a classification depends upon the economic substance of the plan as obtained from its principal terms and conditions.

### (I) What Are Defined Contribution Plans?

As per Defined Contribution Plans, an enterprise's obligation is restricted only to the amount that it agrees to contribute to such a fund. That is to say, the amount of Post-Employment Benefits received by an employee is based on:

- (i) the amount of contributions made by such an enterprise as well as the employee towards this post employment benefit plan or the insurance company and
- (ii) investment returns earned on such contributions

Thus, the actuarial risk, that is benefits would be less than expected and investment risk, that is, assets invested would not be sufficient to pay for the expected benefits, both fall on the employee.

Furthermore, there can be cases where the employee benefit obligation is not just restricted to the amount that such an enterprise agrees to contribute towards the fund. These include the cases when the enterprise has an obligation via:

- (i) a plan benefit formula that is not linked only to the amount of contributions
- (ii) guarantee of a specified returns on the contribution either indirectly via a plan or directly
- (iii) informal practices that lead to an obligation

### Recognition and Measurement

Whenever an employee provides service to an enterprise during an accounting period, the enterprise must identify the contribution payable to a defined contribution plan in exchange for that service.

Such employee benefits are recognized as:

- (i) a liability after deducting any amount of contribution already been paid. Furthermore, if the amount of contribution already paid is more than the contribution due for service before the date of the balance sheet, such excess contribution should be recognized as an asset. This prepayment should be identified as an asset in such a way that it results in reduction in future employee benefit payment or cash refund.
- (ii) as an expense till the time any other accounting standard permits contribution to be included in the cost of the asset.

Furthermore, there can be cases where contributions made to the Defined Contribution Plan do not become due wholly within 12 months after the end of the period after which the employees provide related service.

In such cases, contributions should be discounted using Discount rate as specified in the accounting standard 15.

### (II) What Are Defined Benefit Plans?

As per Defined Benefit Plans the enterprise has an obligation to extend the agreed benefits to both the current as well as the former employees. Furthermore, the

actuarial risk, that is benefits would cost more than expected and investment risk, both fall on the enterprise.

Accounting Treatment for Defined Benefit Plans is complex. This is because actuarial assumptions are needed in order to measure the obligation expense. Furthermore, there are also chances of actuarial gains and losses.

In addition top this, the obligations are measured on discounted basis as such an obligation may be settled years after employees provide the related service.

Therefore, the reporting enterprise may need the services of a qualified actuary in order to measure obligations under Defined Benefit Plans.

### Recognition and Measurement

Defined Benefit Plans may either be unfunded or wholly or partly funded via contributions made by the enterprise and at times made by its employees into an entity or a fund. Such a fund is legally different from the reporting enterprise from which the employees benefits are paid.

Accordingly, the payment of such funded benefits depends not only on the financial position as well as the investment performance of the fund but also on the enterprises potentiality to provide for any any shortfall of the assets of the fund.

As a result, the expense identified for Defined Benefit Plan is not mandatorily the amount of contribution that is outstanding for the given period.

#### Accounting for the Obligation Under a Defined Benefit Plan

The enterprise should account for not only its legal obligation as per the formal terms of the Defined Benefit Plan but also for any other obligation that emerges out of enterprises' informal practices.

Informal practices may lead to an obligation where the enterprise has no other option but to pay for the employee benefits.

### Balance Sheet

The amount to be recognized as a defined benefit liability in the balance sheet should be the net total of the following amounts:

- (i) present value of the defined benefit obligation at the balance sheet date
- (ii) subtract any past service cost not yet recognized
- (iii) subtract the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly

### Statement of Profit and Loss

The enterprise need to recognize the total of the following amounts in the P&L Statement:

- (i) current service cost
- (ii) interest cost
- (iii) expected return on any plan assets and on any reimbursement rights
- (iv) actuarial gains and losses
- (v) past service cost to the extent the accounting standard requires an enterprise to recognize it
- (vi) effect of any curtailments or settlements

### ACTUARIAL ASSUMPTIONS

The actuarial assumptions are nothing but an enterprise's best estimates of the variables that would determine the cost of providing post-employment benefits. These assumptions comprise of:

- (i) Demographic assumptions about the future characteristics of current and former employees eligible for benefits. These include:
  - mortality, both during and after employment
  - rates of employee turnover, disability and early retirement
  - proportion of employees eligible for the benefits under the plan
  - claim rates under medical plans
- (ii) Financial assumptions that deal with aspects like:
  - discount rate
  - future salary and benefit levels
  - future medical costs, including, where material, the cost of administering claims and benefit payments in case of medical benefits
  - expected rate of return on plan assets

### OTHER LONG-TERM EMPLOYEE BENEFITS

Other long-term benefits are nothing but the employee benefits that do not become due wholly due within 12 months subsequent to the end of the period in which the employees offer the related service.

These benefits include:

- (i) long-term compensated absences such as long-service or sabbatical leave
- (ii) jubilee or other long-service benefits
- (iii) long-term disability benefits

- (iv) profit-sharing and bonuses which are payable twelve months or more after the end of the period in which the employees offered the related service
- (v) deferred compensation paid twelve months or more after the end of the period in which it is earned

## RECOGNITION AND MEASUREMENT

### Balance Sheet

The amount to be recognised as a defined benefit liability should be the net total of the following amounts:

- (i) present value of the defined benefit obligation at the balance sheet date
- (ii) subtract the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly

### Statement of Profit and Loss

The enterprise need to recognize the total of the following amounts as expense in the P&L Statement for other long-term employee benefits:

- (i) current service cost
- (ii) interest cost
- (iii) expected return on any plan assets and on any reimbursement rights
- (iv) actuarial gains and losses
- (v) past service cost to the extent the accounting standard requires an enterprise to recognise it
- (vi) effect of any curtailments or settlements

## TERMINATION BENEFITS

As per AS 15, Termination Benefits refer to the employee benefits that are payable as a result of:

- (i) an enterprise's decision to put an end to an employee's employment before the normal retirement date
- (ii) employee's decision to retire voluntarily in lieu of such benefits

AS 15 takes termination benefits different from other employee benefits. This is because the event that results in such an obligation is termination and not employee service.

### Recognition and Measurement

The enterprise must identify the termination benefits as a liability and an expense if only:

- (i) the enterprise has a present obligation on account of a past event
- (ii) it is possible that the outflow of resources that symbolize economic benefits would be needed to settle the obligation
- (iii) amount of estimate can be estimated reliably

**ILLUSTRATION QUESTION**

**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 1**

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 2**

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, post-employment medical care etc.).
- (c) long-term employee benefits (e.g., long-service leave, long-term disability benefits, bonuses not wholly payable within 12 months of the year end etc.), and
- (d) termination benefits (e.g. VRS payments)

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

### Illustration 3

Entity XY is required to pay salary of ₹ 2 crore for the year 20X1-X2. It actually paid a salary of ₹ 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 3

Total expense for the year (20X1-X2)	₹ 2 crore
Amount to be shown under liability (unpaid)	₹ 2 crore – 1.90 ₹crore = ₹ 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 4

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 5

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 ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalization of accounts, taking note of the mandatory accounting standards.

#### Solution 6

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

**Illustration 7**

As on 1st April, 20X1 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 20X1 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 20X2 the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Actuarial losses on the obligations for the year 20X1- 20X2 were ₹ 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 7**

**Computation of Expected and Actual Returns on Plan Assets**

	₹
Return on ₹ 1,00,000 held for 12 months at 10.25%	10,250
Return on ₹ 30,000 (49,000-19,000) held for six months at 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets for 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	<u>49,000</u>
	1,000
Add: Benefits paid	<u>19,000</u>
Actual return on plan assets	<u>20,000</u>

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 ₹ 18 (10% of ₹ 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

- Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.
- The fair value of plan assets on the date is estimated at ₹ 5,100.
- The unamortized past service cost is ₹ 180.
- Curtailment reduces the obligation by ₹ 600, which is 10% of the gross obligation.

#### Solution 8

Gain from curtailment is estimated as under:

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

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

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

#### Illustration 9

An employee Roshan has joined a company XYZ Ltd. in the year 20X1. The annual emoluments of Roshan as decided is ₹ 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 9

#### Calculation of Defined Benefit Obligation (DBO)

Expected last drawn salary = ₹ 14,90,210 × 110% × 110% × 110% × 110% × 110%  
= ₹ 24,00,000

Defined Benefit Obligation (DBO) = ₹ 24,00,000 × 25% × 5 = ₹ 30,00,000

Amount of ₹ 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. ₹ 30,00,000/5 years]	Discounting @ 8% PV factor	Current service cost (Present Value)
a	b	c	d = b × 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 × 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.

**THEORETICAL QUESTIONS**

**Question 6**

What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS 15?

**Solution 6**

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.

PRACTICAL QUESTIONS

**Question 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.

**Solution 7**

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.

**Question 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

**Solution 8**

	₹
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)	<u>8,80,000</u>
Fair market value of plan assets at 31.3.20X2	(B) <u>11,40,000</u>
Actual return on plan assets	(B-A) <u>2,60,000</u>

**Question 9**

The fair value of plan assets of Anupam Ltd. was ₹ 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 ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 20X2 the fair value of plan assets was ₹ 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.

**Solution 9**

**Computation of Expected Returns on Plan Assets as on 31st March, 20X2, as per AS 15**

	₹
Return on opening value of plan assets of ₹ 2,00,000 (held for the year) @ 10.25%	20,500
Add: Return on net gain of ₹ 30,000 (i.e. ₹ 55,000 – ₹ 25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
<b>Expected return on plan assets as on 31st March, 20X2</b>	<b>22,000</b>

**Computation of Actual Returns on Plan Assets as on 31st March, 20X2, as per AS 15**

	₹	₹
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
<b>Actual returns on Plan Assets as on 31st March, 20X2</b>		<b>70,000</b>

## AS 16 - BORROWING COST

### 1. BORROWING COST :

Borrowing Cost includes interest and other costs incurred in connection with borrowed funds.

**Elements of borrowing costs generally include:**

- (1) Interest and commitment charges on bank borrowings
- (2) Discounts and premiums on borrowings to the extent amortized
- (3) Other ancillary costs for arranging borrowings to the extent amortized
- (4) Finance charges in respect of assets under Finance lease, Hire purchase
- (5) Exchange rate differences relatable to foreign currency borrowings, to the extent that they are regarded as an adjustment to interest costs.

### 2. QUALIFYING ASSET :

Qualifying Asset Is an asset that necessarily takes substantial period of time to get ready for its:

- **Intended** use [Fixed Assets or Investment properties], OR
- Sale [Inventory]

#### **Note:**

Ordinarily a period of 12 months is considered substantial period unless a shorter or longer period can be justified.

The following are, however, not qualifying assets:

- Inventories routinely manufactured
- Inventories produced in large quantities on repetitive basis over short period
- Assets ready for intended use at the time of acquisition

### 3. ACCOUNTING FOR BORROWING COSTS :

#### Accounting Treatment - Borrowing Costs

Sr. No.	Nature of borrowing costs	Accounting treatment prescribed by AS-16	Remarks
1.	Borrowing costs that are directly attributable to the acquisition construction or production of a qualifying asset	Capitalize as part of the cost of that asset (i.e. include in the cost of that assets)	Amount to be capitalized period for which capitalization should be done to be determined as per AS-16.
2.	Other borrowing costs	To be expensed in the period in which they are incurred -	-

From the above table, it is clear that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of cost of that asset.

### 4. SPECIFIC AND GENERAL BORROWINGS :

Borrowing costs can be related to either specific borrowings, or general borrowings.

(i) **Specific Borrowings:**

As a general rule, specific borrowings are those which could have been avoided, but for expenditure on Qualifying Asset. In this case, capitalisation rate is done for the “actual borrowing costs” incurred.

Income on temporary investment of funds forming part of specific borrowings alone should be deducted from borrowing cost & ONLY net amount should be capitalized.

(ii) **General Borrowings:**

Under this category, falls more than one type of borrowing (loans, debentures ICDs, working capital borrowings, etc) used – either wholly or partly for expenditure on Qualifying Asset. In this case, capitalisation rate will be “weighted average of the borrowing costs outstanding” during the relevant period

(iii) **Capitalisation ceiling:**

Borrowing cost capitalized should not exceed borrowing cost actually incurred during the period. This situation will arise in the case of general borrowings.

## 1. CAPITALISATION CRITERIA :

### A. Commencement of Capitalisation:

The borrowing cost incurred on qualifying asset is to be capitalized only if all the three following conditions are fulfilled

- Expenditure on Qualifying Asset is being incurred
- Borrowing Costs are incurred
- Activities are in progress; such activities include technical/administrative work also. However, it does not include those, which do not result in a change in the condition of the asset.

It follows, therefore, that there would be circumstances in which capitalisation of borrowing costs are either to be suspended or stopped.

### B. Suspension of capitalization:

It is possible that after commencement of capitalisation of Borrowing Cost, one or more of the three conditions (stated above) may not subsequently be fulfilled. Activities could stand suspended for (i) **avoidable reasons**, or (ii) **for unavoidable reasons**.

#### **Suspension of activity for avoidable reasons (do not capitalise)**

Where activity necessary to prepare the asset for its intended use or sale stands suspended.

- Over extended periods, and
- **Active** development is interrupted

Borrowing Cost incurred during such periods of suspension represents cost of holding incomplete asset and hence **should** not be capitalized.

Suspension of activity for unavoidable reasons (can continue to capitalise subject to prudence)

The suspension which is in the nature of temporary delay and where such delay is necessary for getting asset ready, e.g., maintaining of inventory (wine) and high water level for bridge construction, the borrowing cost should be capitalized.

### C. Cessation of capitalization – stoppage

Capitalization of borrowing costs should cease when:

- All activities necessary for making assets ready for intended use/sale are substantially complete

- Items of administrative work or finishing touches to be completed happen to be minor in nature
- Where an asset is completed “in parts”, and completed part is capable of use, when work on others is in progress, capitalization for completed part should be stopped.

**2. DISCLOSURE REQUIREMENTS:**

1. The accounting policy followed for treatment of borrowing costs
2. The amount of borrowing costs capitalized during the period

CLASSWORK QUESTIONS

**Question 1**

Paras Ltd. has the following borrowings during a year in respect of capital expansion.

Plant	Cost of Asset (₹)	Remarks
Plant P	100 lakhs	No Specific Borrowings
Plant Q	125 lakhs	Bank loan of ₹ 65 lakhs at 10%
Plant R	175 lakhs	9% Debentures of ₹ 125 lakhs were issued.

In addition to the specific borrowings stated above, the company had obtained term loans from banks (1) ₹ 100 lakhs at 10% from corporation Bank and (2) ₹ 110 lakhs at 11.5% from State Bank of India to meet its capital expansion requirements. Determine the amount of borrowing costs to be capitalized in each of the above plants, as per AS 16.

**Question 2**

Axe Limited began construction of a new plant on 1st April, 2011 and obtained a special loan of ₹4,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.

The expenditure that were made on the project of plant were as follows:

	₹
1st April, 2011	5,00,000
1st August, 2011	12,00,000
1st January, 2012	2,00,000

The company's other outstanding non-specific loan was ₹ 23,00,000 at an interest rate of 12%.

The construction of the plant completed on 31st March, 2012. You are required to:

- Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".
- Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.

**Question 3**

Shan Builders Limited has borrowed a sum of US \$ 10,00,000 at the beginning of Financial Year 2014-15 for its residential project at LIBOR + 3 %. The interest is payable at the end of the Financial Year. At the time of availment, exchange rate was ₹ 56 per US \$ and the rate as on 31st March, 2015 ₹ 62 per US \$. If Shan Builders Limited borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%.

Compute Borrowing Cost and exchange difference for the year ending 31st March, 2015 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

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**CLASSWORK SOLUTIONS**

**Answer 1**

Calculation of capitalization Rate for general borrowings:

Interest on Corporation Bank Loan	= ₹ 100 Lakhs × 10%	= ₹ 10,00,000
Interest on SBI Loan	= ₹ 110 Lakhs × 11.5%	= ₹ 12,65,000
Total Borrowing Cost	= ₹ 22,65,000	
Total Borrowing	= ₹ 100 Lakhs + ₹ 110 Lakhs	
	= ₹ 210 Lakhs.	

$$\begin{aligned} \therefore \text{Capitalisation Rate} &= \frac{\text{Total Borrowing Cost}}{\text{Total Borrowing}} \times 100 \\ &= \frac{\text{₹22.65 lakhs}}{\text{₹210 lakhs}} \times 100 \\ &= 10.79\% \end{aligned}$$

Calculation of interest to be Capitalised

Plant	Cost	General Borrowing Cost	Specific Borrowing Cost	Total Borrowing Cost
P	100	10.79 (100 × 10.79%)	-	10.79
Q	125	6.474 (60 × 10.79%)	6.5 (65 × 10%)	12.974
R	175	5.395 (50 × 10.79%)	11.25 (125 × 9%)	16.645
		22.659 ≈ 22.65 lakhs	17.75	40.409

**Answer 2**

1. Computation of average accumulated annual investment in qualifying asset:

		₹
1st April, 2011	₹ 5,00,000 × $\frac{12}{12}$	5,00,000
1st August, 2011	₹ 12,00,000 × $\frac{8}{12}$	8,00,000
1st January, 2012	₹ 2,00,000 × $\frac{3}{12}$	50,000
	Average Annual Investment	13,50,000

2. Amount of interest capitalised

	₹
On specific borrowing (₹4,00,000 × 10%)	40,000
On non-specific borrowing (₹ 13,50,000 – ₹ 4,00,000) = 9,50,000 × 12%	1,14,000
Amount on interest to be capitalized	1,54,000



## AS 17 - SEGMENT REPORTING

### 1. MEANING :

- An enterprise deals in multiple Products/Services and operates in different Geographical areas, which expose to **Significantly different risk and rewards/returns**.
- **Information** about Multiple Products/Services and operations in different Geographical areas is called **Segment Information**.
- **Disclosure** of such information is called segment reporting.

### 2. SEGMENT REPORTING HELPS USERS OF FINANCIAL STATEMENTS :

- (1) To better understand the **PERFORMANCE** of the enterprise;
- (2) To better assess the **RISKS AND RETURNS** of the enterprise;
- (3) To make more informed judgements about the enterprise as a whole.

### 3. SEGMENT REPORTING :

The segment report is made as per Accounting Standard - 17 which is mandatory and is effective for the accounting periods starting on or after 1.04.2003. The Accounting Standard is mandatory for listed companies or companies intending to be listed or whose turnover exceeds 50 crores.

### 4. TYEPS OF SEGMENT :

Segmentation can be done on the basis of products on services or a group of related products & services. Segmentation can also be geographical. Whether segmentation should be primarily product wise or geographical depends on whether primary risk is due to products or services or due to geographical area. To identify the primary risk the internal organisation & management structure & its system of reporting to the Board of Directors or CEO of the company should be considered.

### 5. BUSINESS SEGMENT :

A business segment is a distinguishable component of an enterprise which is engaged in providing an individual product or service or a group of related products or services and that is subject to risks & returns which are different from those of other segments. Factors which would be considered in determining whether products or service are related includes :

- (a) Nature of products or services
- (b) Nature of production process
- (c) Type of or class of customers for products or services
- (d) The methods used to distribute the products or provide the services
- (e) Nature of regulatory environment.

#### 6. GEOGRAPHICAL SEGMENT :

A geographical segment is a distinguishable component of an enterprise which is engaged in providing products or services within a particular economic environment and it is subject to risks and returns that are different from those of other segments operating in other economic environment. It includes:

- (a) Similarity of economic & political conditions.
- (b) Relationship between operations
- (c) Proximity of operations
- (d) Special Risks
- (e) Exchange Control Regulations
- (f) Underlying Currency Risks

The risks & returns of an enterprise are categorised by geographical location of its assets and location of its customers.

**NOTE:**

Determining the composition of a business or geographical segment involves a certain amount of judgment.

#### 7. REPORTABLE SEGMENT :

It is a business or geographical is identified on the basis of the foregoing definition for which segment information is required to be disclosed by the financial statements.

- (i) Para 27 a of Accounting Standard - 17 states that if total revenue (External + Intersegment) of a segment is 10% or more of total revenue of all segment then those segments are reportable.
- (ii) Para 27 b states that if the result i.e. profit or loss of any segment is 10% or more of combined profit / combined loss of all segments in absolute terms then that segment is reportable.
- (iii) Para 27 c states that if assets of any segment is 10% or more than the total assets of all segments then that segment is reportable.
- (iv) Para 28 states that management may designate any segment as reportable even if it doesn't satisfy above mentioned criteria.

- (v) Para 29 requires that if the total external revenue of reportable segments identified as per para 27 & 28 is less than 75% of total enterprise revenue, additional segments should be identified as reportable till limit of 75% is reached.

## 8. DISCLOSURE :

Accounting Standard - 17 is a reporting standard. Hence "disclosures" is its core element. The intensity of disclosures is high in case of primary segments and low for secondary segments.

For each Primary segment the following disclose have to be made.

- (a) Segment Revenue (External + Internal segment)
- (b) Segment Result
- (c) Segment Assets.
- (e) Segment Liabilities
- (f) Capital expense incurred during the period
- (g) Depreciation charge for the period
- (h) Other non-cash expenses during the period.

### Disclosure required for secondary segments.

If Business segments are primary then geographical segments are secondary. Disclose:

- Revenue from external customers by geographical location (10% Test)
- Assets by geographical location of assets (10% Test)
- Fixed Asset acquired during the period.

If Geographical segs are primary then Business segs are secondary. If a business seg's external sales are  $\geq 10\%$  of total external revenue or Business segment assets are  $\geq 10\%$  of total assets of all business segs, then disclose for those business segments:

- Segments revenue from external customers.
- Segments assets
- Fixed assets acquired during the period.

Also if the primary geographic segments are based on location of customers, also make the following disclosures:

- Assets located in each geographic segment (10 % Test)
- Additions to fixed assets during the period.

If the Primary geographic segments are based on location of assets, also make the following disclosure:

- Sales to external customers for each customer based geographical segment (10% Test).

**CLASSWORK QUESTIONS**

**Question 1**

The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:

₹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.

**Question 2**

M/s XYZ Ltd. has three segments namely X, Y, Z. The total Assets of the Company are ₹ 10.00 crores. Segment X has ₹ 2.00 crores, segment Y has ₹ 3.00 crores and segment Z has ₹ 5.00 crores. Deferred tax assets included in the assets of each segments are X - ₹ 0.50 crores, Y - ₹ 0.40 crores and Z - ₹ 0.30 crores.

The accountant contends that all the three segments are reportable segments. Comment.

**Question 3**

XYZ Ltd. has 5 business segments. Profit / Loss of each of the segments for the year ended 31st March, 2022 has 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) ₹ in lakhs
A	225
B	25
C	(175)
D	(20)
E	(105)

(May' 22)

CLASSWORK SOLUTIONS

**Answer 1**

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 at least 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 of ₹ 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 upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant is wrong.

**Answer 2**

According to AS 17 "Segment Reporting", segment assets do not include income tax assets.

Therefore, the revised total assets are ₹ 8.8 crores [₹ 10 crores – (₹ 0.5 + ₹ 0.4 + ₹ 0.3)].

Segment X holds total assets of ₹ 1.5 crores (₹ 2 crores – ₹ 0.5 crores); Segment Y holds

₹ 2.6 crores (₹ 3 crores – ₹ 0.4 crores); and Segment Z holds ₹ 4.7 crores (₹ 5 crores –

₹ 0.3 crores). Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

**Answer 3**

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. ₹ 250 Lakhs or

- The combined result of all segments in loss; i.e. ₹ 300 Lakhs

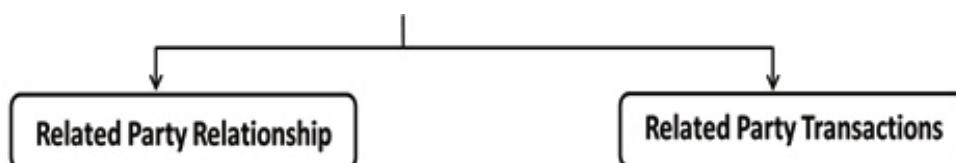
Whichever is greater in absolute amount i.e. ₹ 300 Lakhs.

Operating Segment	Absolute amount of Profit or Loss (₹ 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 of ₹ 300 lakhs i.e. 30 lakhs).

## AS 18 - RELATED PARTY DISCLOSURES

### Disclosure Requirement



#### 1. RELATED PARTY :

Any party that Controls or can significantly influence the management or operating policies of the company during the reporting period.

##### ➤ Control

One party has the ability to control the other party in following ways.

- Control by Ownership (directly or indirectly) more than 50% of Voting Power.
- Control over Composition of Board of Direction or other Governing body.
- Control of Substantial interest in the Voting Power and power to direct the Financial and operating policies.

##### ➤ SIGNIFICANT INFLUENCE :

It refers to Power to Participate in the Financial and/or Operating Policy decisions of an enterprise but not control of those policies.

Significant influence may be gained by

- Ownership [Generally 20% or more interest in Voting Power]
- Statute
- Agreement.

#### 2. Related Party Relationships :

**AS 18 deals with the Following related party relationships only :**

- (i) Enterprises that directly, or indirectly through one or more intermediaries, control or are controlled by, or are under common control with, the reporting enterprise (This includes Holding Companies, Subsidiaries and Fellow Subsidiaries).
- (ii) Associates and joint ventures of the reporting enterprise.

- (iii) 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.

**Relative Means:**

- Spouse
- Son
- Daughter
- Brother
- Sister
- Father
- Mother

- (iv) Key management personnel and relatives of such personnel.

**Key Managerial Personnel:** Who has authority and responsibility for Planning, Directing and controlling the activities of reporting enterprise.

- (v) Enterprises over which individual or KMP (define above) is able to exercise significant influence.

[This includes enterprises owned by directors or major shareholders of the reporting enterprise]

**3. EXCEPTION OF RELATED PARTY RELATIONSHIP :**

Following relationship will be deemed not as related party: \_\_\_\_\_

- Two companies have a common director but director is not able to influence the Mutual dealing between companies.
- A single customer or supplier or franchiser or distributor or general agent with whom enterprise transactions are in significant Volume.
- Providers of finance
- Trade unions
- Government departments and Agencies

**4. EXEMPTION FROM DISCLOSURE REQUIREMENT OF AS 18**

If disclosure would conflict with the reporting enterprise statutory duties of Confidentiality.

**For Example**

Banks are obliged by law to maintain confidentiality in respect of their customers transactions.

### 5. Related Party Transactions:

It means a transfer of resource or obligations between related Parties regardless of whether or not a price is charged.

#### Examples:

- Purchase or Sale of Goods [Finished or unfinished]
- Purchase or Sale of Fixed Assets
- Rendering or receiving of services
- Leasing or Hire purchase arrangement
- Transfer of Research and Development
- License Agreements
- Finance [including loan and Equity contribution]
- Guarantees

### 6. DISCLOSURE:

- If Related Party Relationship is based on control, disclosure about relationship [i.e. Name and nature of relationship] be given even if there is no transaction with the related party.
- If Related Party Relationship is based on significant influence, disclosure need to be given only if transactions are there with the related party.

CLASSWORK QUESTIONS

**Question 1**

Identify the related parties in the following cases as per AS 18

A Ltd. holds 51% of B Ltd.

B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

**Question 2**

Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3 2017. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?

**Question 3**

Mr. Raj a relative of key management personnel received remuneration of ₹ 2,50,000 for his services in the company for the period from 1.4.2016 to 30.6.2016. On 1.7.2016, he left the service.

Should the relative be identified as at the closing date i.e. on 31.3.2017 for the purposes of AS 18?

CLASSWORK SOLUTIONS

**Answer 1**

**Reporting entity- A Ltd.**

- B Ltd. (subsidiary) is a related party
- O Ltd.(subsidiary) is a related party

**Reporting entity- B Ltd.**

- A Ltd. (holding company) is a related party
- O Ltd. (subsidiary) is a related party

**Reporting entity- O Ltd.**

- A Ltd. (holding company) is a related party
- B Ltd. (holding company) is a related party
- Z Ltd. (investor/ investing party) is a related party

**Reporting entity- Z Ltd.**

- O Ltd. (associate) is a related party

**Answer 2**

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.

**Answer 3**

As per AS18, key management personnel and relative of such personnel are those who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. Therefore the KMP and relative of such KMP are related to the enterprise.

In the given case Mr Raj received remuneration from the enterprise for the services rendered, as he is the relative of KMP, Mr Raj is related party to the enterprise. Therefore the enterprise has to report this transaction as a related party transaction as per AS 18 on 31.03.2017, even if he left services as on 1st July 2016.

## AS 19 - LEASES

### 1. INTRODUCTION:

#### (a) OBJECTIVE:

The objective of AS 19 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

#### (b) DEFINITION:

A Lease is an agreement whereby the Lessor (legal owner of an asset) conveys to the Lessee (another party) in return for a payment or series of periodic payments (Lease rents), the right to use an asset for an agreed period of time.

#### (c) Applicability of AS 19:

The standard applies to all leases other than:

- (a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and
- (b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- (c) lease agreements to use lands
- (d) agreements that are contracts for services, that do not transfer right to use assets from one contracting party to the other.

### 2. TYPE OF LEASE :

For the purpose of accounting the lease is classified into two categories as follows

- (a) Finance lease
- (b) 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. In following situations, the lease transactions are called finance lease:

- The lessee will get the ownership of leased asset at the end of the lease term.
- The lessee has an option to buy the leased asset at the end of term at price, which is lower than its expected fair value on the date on which option will be exercised.

- The lease term covers the major part of the life of asset.
- At the beginning of lease term, present value of minimum lease rental covers substantially the initial fair value of the leased asset.
- The asset given on lease to lessee is of specialized nature and can be used by the lessee without major modification.

**Operating lease :** It is a lease which does not transfer substantially all the risks and rewards incidental to ownership.

It is a lease other than financial lease.

### 3. ACCOUNTING FOR FINANCE LEASE – IN THE BOOKS OF LESSEE :

Following is the accounting treatment of Finance Leases in the books of Lessee:

- (i) On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:
  - Fair value of leased asset at the inception of the lease
  - Present value of minimum lease payments from the standpoint of the lessee (present value to be calculated with discount rate equal to interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used)
- (ii) Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.
- (iii) Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.
- (iv) A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in AS 10 (Revised), Property, Plant and Equipment. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.
- (v) Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.



another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

- (iii) Depreciation should be recognised in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10.
- (iv) The impairment losses on assets given on operating leases are determined and treated as per AS 28.

## 6. SALE AND LEASEBACK:

The basis of a sale and leaseback agreement is simply that one sells an asset for cash and then leases it back from the buyer. The asset subject to such sale and leaseback agreement is generally property. Under such an agreement the property owner agrees to sell the property at an agreed valuation and lease it back from the buyer. The lessee or seller receives cash immediately and makes periodic payment in form of lease rents for right to use the property. The lease payments and the sale price are generally interdependent as they are negotiated as a package. The accounting treatment of a sale and lease back depends upon the type of lease involved. Accounting treatment of profits / losses on sale of asset, as required by the standard in respect of sale and lease-back transactions, are summarised below.

- **Where sale and leaseback results in finance lease**

The excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

- **Where sale and leaseback results in operating lease**

**Case 1: Sale price = Fair Value**

**Profit or loss should be recognised immediately.**

**Case 2: Sale Price < Fair Value**

Profit should be recognised immediately. The loss should also be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

**Case 3: Sale Price > Fair Value**

The excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

## 7. DISCLOSURE :

The following disclosures in financial statements of the lessee and lessor should be made as regards lease.

### Disclosure in operating lease by lessor –

- ◆ General description of significant leasing arrangements
- ◆ Accounting policy for initial direct payment
- ◆ Future lease payments in aggregate classified as :
  - not later than one year;
  - later than one year but not later than five years;
  - later than five years;

### Disclosure in operating lease by the lessee-

- ◆ General description of significant leasing arrangements.
- ◆ Total of future minimum lease payments in following period :
  - not later than one year;
  - later than one year but not later than five years;
  - later than five years;
- ◆ lease payments recognized in Profit & Loss A/c for the period.

### Disclosure in finance lease by the lessor -

- ◆ General description of the significant leasing arrangement.
- ◆ Accounting policy for initial direct cost.
- ◆ Reconciliation of total gross investment in lease with present value of MLP receivable on balance sheet date.
- ◆ Minimum lease payment (MLP) receivable in following categories :
  - not later than one year;
  - later than one year but not later than five years;
  - later than five years;

### Disclosure in finance lease by the lessee -

- ◆ Asset under finance lease segregated from an asset owned.
- ◆ Reconciliation of total MLP with its present value on balance sheet date.
- ◆ MLP in following categories on balance sheet date :
  - not later than one year;
  - later than one year but not later than five years;
  - later than five years;

**CLASSWORK QUESTIONS**

**Question 1**

AD Softex Ltd. has taken the assets on lease from ACS Impex Ltd. the information is given below:

Lease term	= 4 years
Fair value at inception of lease	= ₹ 16,00,000
Lease Rent	= ₹ 5,00,000 p.a. at the end of year
Guaranteed Residual Value	= ₹ 1,00,000
Expected Residual Value	= ₹ 3,00,000
Implicit Interest Rate	= 14.97%

Do the accounting in the books of lessee & lessor.

**Question 2**

NDA Ltd. availed a lease from Induga Ltd. on following terms :

- ◆ A lease for a tenor of 3 years, in the beginning of year 2001 for equipment costing ₹ 7,00,000 and which has an expected useful life of 5 years. The fair market value is also ₹ 7,00,000.
  - ◆ 3 equal annual payments are made at end of each year.
  - ◆ The property reverts back to the lessor on termination of the lease.
  - ◆ The unguaranteed residual value is estimated at ₹ 75,000 at the end of year 2003
  - ◆ IRR = 10%
  - ◆ The present value of Re. 1 due at the end of 3rd year at 10% rate of interest is 0.7513
  - ◆ The present value of annuity of Re. 1 due at the end of 3rd year at 10% IRR is ₹ 2.4868
- (i) State with reason whether the lease constitute finance lease.
- (ii) Calculate unearned finance income

**Question 3**

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

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

**CLASSWORK SOLUTIONS**

**Answer 1**

**In the books of Lessee**

Present value of minimum lease payment

Year	MLP	Discount rate at 4.97%	PV
1	5,00,000	.8698	4,34,900
2	5,00,000	.7565	3,78,250
3	5,00,000	.6580	3,29,000
4	6,00,000 (Including Rs. 1,00,000)	.5724	3,43,440
	<b>21,00,000</b>		<b>14,85,590</b>

Present value of minimum lease payment (RS. 14,85,590) is less than Fair value at the inception of lease (Rs. 16,00,000), so the leased asset and liability should be recognized at Rs. 14,85,590.

Apportionment of Finance Lease:

Rate of Interest 14.97%

Year	Liability	MLP	Finance Charge	Principal Amt. of reduction
0	14,85,590	-	-	-
1	12,07,983	5,00,000	2,22,393	2,77,607
2	8,88,818	5,00,000	1,80,835	3,19,165
3	5,21,874	5,00,000	1,33,056	3,66,944
4	-	6,00,000	78,125	5,21,875

**Books of AD Softex**

**Lease Rent Account**

1st Year	To Bank	5,00,000	By Finance Charge	2,22,393
			By Lease liability A/c	2,77,607
		5,00,000		5,00,000
2nd Year	To Bank	5,00,000	By Finance Charge	1,80,835
			By Lease liability A/c	3,19,165
		5,00,000		5,00,000

3rd Year	To Bank	5,00,000	By Finance Charge	1,33,056
			By Lease liability A/c	3,66,944
		5,00,000		5,00,000
4th Year	To Bank	6,00,000	By Finance Charge	78,126
			By Lease liability A/c	5,21,874
		6,00,000		6,00,000

**Lease Liability Account (Lessor)**

1st Year				
To Lease Rental		2,77,607	By Fixed Asset under	14,85,590
To Balance c/d		12,07,983	Finance Lease	
		14,85,590		14,85,590
2nd Year				
To Lease Rental		3,19,165	By balance b/d	12,07,903
To Balance c/d		8,88,818		
		12,07,903		12,07,903
3rd Year				
To Lease Rental		3,66,944	By balance b/d	8,88,818
To Balance c/d		5,21,874		
		8,88,818		8,88,818
4th Year				
To Lease Rent		5,21,874	By balance b/d	
		5,21,874		5,21,874

**Answer 2**

At IRR , PVGI = Fair Value of asset,

Net Investment = Rs. 7,00,000

Year	Cash flow	Disc. Factor @ 10%	PV
1	?	0.9091	#
2	?	0.8264	
3	?	0.7513	
3	75,000	0.7513	56348
			= 7,00,000

# + 56348 = 700000

# = 700000 - 56348

# = 643652

Now, PV of lease rentals = Lease rental p.a (x) Annuity Factor

$$643652 = LR (x) 2.4868$$

$$\text{Lease rental p.a} = 258827$$

$$\begin{aligned} \text{(i) PV of MLP} &= \text{PV of LR} + \text{PV of GRV} \\ &= 643652 + \text{NA} \\ &= 643652 \end{aligned}$$

$$\begin{aligned} \text{PV of MLP/ FV of Asset} \times 100 &= 643652/700000 \times 100 \\ &= 91.95\% \end{aligned}$$

Since PV of MLP substantially covers the FV of Asset

The given lease rental is Finance lease

$$\begin{aligned} \text{(ii) Unearned Finance income} &= \text{GI} - \text{NI} \\ &= (\text{LR} + \text{GRV} + \text{UGRV}) - 700000 \\ &= [(258827 \times 3) + \text{NIL} + 75000] - 700000 \\ &= \text{Rs } 151481 \end{aligned}$$

### Answer 3

Following will be the treatment in the given cases:

- (i) When sales price of Z 50 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of ₹ 10 lakhs (i.e. 50 – 40) in its books.
- (ii) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment.
- (iii) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortised over the lease period.
- (iv) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46-40) to be immediately recognised in its books and balance profit of ₹ 4 lakhs (50-46) is to be amortised/deferred over lease period.
- (v) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognised by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period.

## AS 20 - EARNINGS PER SHARE

### 1. INTRODUCTION :

The objective of AS 20 is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.

### 2. TYPES OF EPS :

There are two types of earning per share (EPS), which are to be reported by an enterprise on the face of the statement of profit and loss:

- Basic EPS
- Diluted EPS

### 3. BASIC EPS:

Basic EPS is calculated as under

$$\text{Basic Earning Per Share} = \frac{\text{Net profit / loss for the period attributable to equity shareholder.}}{\text{Weighted average number of equity shares outstanding during the period.}}$$

### 4. Calculation of Net Profit / Loss for the period attributable to equity shareholders.

- Calculate the net profit / loss for the period including prior period items and extraordinary items as per AS-5 and also deduct tax expense (Current tax + Deferred tax) unless the AS-5 requires otherwise.
- Deduct the amount of preference dividend and any attributable tax on preference dividend from the figure calculated above. Dividend on non-cumulative preference share is deducted if dividend is provided. However, in case of cumulative preference share, dividend of current year is deducted even if not provided in accounts. Dividend paid during the current year in respect of previous periods is to be excluded.

### 5. Per Share - Basic

The number of shares used in the denominator for basic EPS should be the weighted average number of equity shares outstanding during the period.

The weighted average number of equity shares outstanding during the period is the number of shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by a time-weighting factor.

### 6. EFFECTIVE DATES :

List of shares issued, which are to be adjusted	Weight to be considered from
➤ Equity shares issued in exchange of cash.	Date of cash receivable
➤ Equity shares against conversion of debt instrument	Date of conversion
➤ Equity shares against interest or principal of any financial instrument	Date when interest ceases to accrue.
➤ Equity shares issued in exchange for the settlement of a liability of the enterprise.	Date on which settlement becomes effective.
➤ Equity shares issued in consideration of acquisition of assets other than cash.	Date on which acquisition is recognised.
➤ Equity shares issued against services rendered.	When service is rendered
➤ Partly paid up share	Partly paid up equity should be counted as fraction of equity shares in ratio of amount paid up to the total face value of the share. 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.
➤ Right issue.	Adjusted with Right Factor.
➤ Equity shares issued as consideration in amalgamation by way of:	

(i) Merger	Shares included in the calculation of weighted average from the beginning of the reporting period.
(ii) Purchase	Included in the weighted average from the date of acquisition.
➤ Bonus share	Shares included in weighted average from the beginning of the reporting period.

### 7. IMPACT OF BONUS ISSUE:

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

- (a) A bonus issue;
- (b) A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;
- (c) A share split; and
- (d) A reverse share split (consolidation of shares).

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

### 8. RIGHT ISSUE:

Right issue is generally made at a price lower than fair value of share. Therefore, a right issue usually includes a bonus element. Since right issue includes a bonus element, the number of equity shares to be used in calculating basic EPS for all periods prior to right issue is the number of equity shares outstanding prior to the issue multiplied by right factor which is calculated as under:

$$\text{Right Factor} = \frac{\text{Fair value per share immediately prior to right issue}}{\text{Theoretical Ex-Right fair value per share}}$$

Theoretical Ex-Right fair value:

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

Computation of WANES

$$\left( \text{No. of shares outstanding at the beginning of the year} \times \text{RF} \times \frac{\text{No. of Months upto Rights}}{12} \right) +$$

$$\left( \text{Total No of shares after rights} \times \frac{\text{No. of remaining Months}}{12} \right)$$

### 9. DILUTED EARNING PER SHARE :

Diluted earning per share is calculated when there are potential equity shares in capital structure of the enterprise. A potential equity share is that financial instrument which entitles the holder the right of equity shares like convertible debentures, convertible preference shares, options, warrants, etc.

Diluted Earning Per Share

$$= \frac{\begin{array}{l} \text{Net profit attributable to equity shareholders} \\ \text{(after adjustment for diluted earnings)} \end{array}}{\text{Average number of weighted equity shares outstanding during the period (assuming the conversion of diluted potential equity shares)}}$$

#### ➤ Diluted Earning

- Compute net profit or loss for the period attributable to existing equity shareholder.
- Add back dividend along with distribution tax on convertible preference shares previously deducted.
- Add back interest net of tax effect charged on convertible debenture or loans.

### 10. PRESENTATION:

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented. AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

**CLASSWORK QUESTIONS**

**Question 1**

Net profit for the year 31.3.2016 ₹ 18,00,000  
 Net profit for the year 31.3.2017 ₹ 60,00,000  
 No. of equity shares outstanding until 31.3.2016 ₹ 20,00,000  
 Bonus issue 1st October 2016 was 2 equity shares for each equity share outstanding at 31.3.2016.  
 Calculate Basic Earnings Per Share and Adjusted Earnings Per Share.

**Question 2**

Net profit for the year 2016 ₹ 11,00,000  
 Net profit for the year 2017 ₹ 15,00,000  
 No. of shares outstanding prior to rights issue 5,00,000 shares  
 Rights issue price ₹ 15.00  
 Last date to exercise rights 1st March 2017  
 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 2017 was ₹ 21.00. Compute Basic Earnings per share of 2016 & 2017. Also calculate restated EPS of 2016.

**Question 3**

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

Compute Diluted Earnings Per Share.

**Question 4**

From the following information pertaining to A Ltd., compute BEPS and DEPS  
 Profit available for equity shareholders = 20,00,000  
 Equity Share Capital of ₹ 10 each = 8,00,000  
 Convertible 12% Preference share of ₹ 100 = 16,00,000  
 Each preference share is convertible into 2 equity shares.

**Question 5**

Net profit for the year 2017	12,00,000
Weighted average number of equity shares outstanding during the year 2017	5,00,000 shares
Average fair value of one equity share during the year 2017	20.00
Weighted average number of shares under option during the year 2017	1,00,000 shares
Exercise price for shares under option during the year 2017	15.00

Compute Basic and Diluted Earnings Per Share.

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CLASSWORK SOLUTIONS

Answer 1

Net profit for the year 20X0	Rs. 18,00,000
Net profit for the year 20X1	Rs. 60,00,000
No. of equity shares outstanding until 30th September 20X1	20,00,000
Bonus issue 151 October 20X1	2 equity shares for each equity share outstanding at 30 <sup>th</sup> September, 20X1 $20,00,000 \times 2 = 40,00,000$
Earnings per share for the year 20X1	Rs. 60,00,000 (20,00,000 + 40,00,000) = Re. 1.00
Adjusted earnings per share for the year 20X0	Rs.18,00,000 (20,00,000 + 40,00,000) = Re. 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 20X0, the earliest period reported.	

Answer 2

Net profit	Year 20X0 : Rs. 11,00,000 Year 20X1 : Rs. 15,00,000
No. of shares outstanding prior to rights issue	5,00,000 shares
Rights issue	One new share for each five outstanding (i.e. 1,00,000 new shares) Rights issue price : Rs. 15.00 Last date to exercise rights: 1st March 20X1
Fair value of one equity share immediately prior to exercise of rights on 18' March 20X1	Rs. 21.00
<p>Computation of theoretical ex-rights fair value per share</p> <p style="text-align: center;">Fair value of all outstanding shares immediately prior to exercise of rights + total amount received from exercise</p> <hr/> <p style="text-align: center;">Number of shares outstanding prior to exercise + number of shares issued in the exercise</p> <p style="text-align: center;"><u>(Rs. 21.00 × 5,00,000 shares) + (Rs. 15.00 × 1,00,000 shares)</u> 5,00,000 shares + 1,00,000 shares</p> <p style="text-align: center;">Theoretical ex-rights fair value per share = Rs. 20.00</p>	

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	Year 20X0	Year 20X1
EPS for the year 20X0 as originally reported: Rs. 11,00,000/5,00,000 shares	Rs. 2.20	
EPS for the year 20X0 restated for rights issue: Rs. 11,00,000/(5,00,000 shares x 1.05)	Rs. 2.10	
EPS for the year 20X1 including effects of rights issue  Rs. 15,00,000 <hr/> (5,00,000 x 1.05 x 2/12) + (6,00,000 x 10/12)		Rs. 2.55

**Answer 3**

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	
Each debenture is convertible into 10 equity shares	1,00,000
Interest expense for the current year	Rs. 12,00,000
Tax relating to interest expense (30%)	Rs. 3,60,000
Adjusted net profit for the current year	Rs. (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
No. of equity shares used to compute diluted earnings per share	50,00,000 + 10,00,000 = 60,00,000
Diluted earnings per share	1,08,40,000/60,00,000 = Re. 1.81

**Answer 4**

First, calculate the number of equity shares upon conversion of preference shares:

Number of preference shares = Rs. 16,00,000 / Rs. 100 = 16,000 shares

Number of equity shares upon conversion = 16,000 shares × 2 = 32,000 shares

Now, calculate BEPS:

BEPS = (Profit available for equity shareholders) / (Number of equity shares)

BEPS = Rs. 20,00,000 / 32,000 shares = Rs. 62.50 per share

Next, calculate DEPS. To calculate DEPS, you need to consider the impact of the convertible preference shares as if they were converted at the beginning of the period:

DEPS = (Profit available for equity shareholders + Preference Dividend) / (Number of equity shares + Number of equity shares upon conversion)

Preference Dividend = Number of preference shares × Convertible preference dividend per share

Preference Dividend = 16,000 shares × (12% of Rs. 100) = Rs. 1,92,000

DEPS = (Rs. 20,00,000 + Rs. 1,92,000) / (32,000 shares + 32,000 shares)

DEPS = Rs. 21,92,000 / 64,000 shares = Rs. 34.25 per share

So, as per AS 20, the Basic Earnings Per Share (BEPS) is Rs. 62.50 per share, and the Diluted Earnings Per Share (DEPS) is Rs. 34.25 per share.

**Answer 5**

Computation of earnings per share

	Earnings	Share	Earnings per share
Net profit for the year 20X1	Rs. 12,00,000		
Weighted average number of shares outstanding during year 20X1		5,00,000	
Basic earnings per share			Rs. 2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value: (100,000 × 15.00)/20.00	*	(75,000)	
Diluted earnings per share	Rs. 12,00,000	5,25,000	Rs. 2.29

\*The earnings have not been 'ncreased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration (see para 37x(b))

## AS 22 - ACCOUNTING FOR TAXES ON INCOME

### 1. SCOPE :

The Standard deals with the taxes on Income (Domestic taxes as well as Foreign taxes) Excluding Dividend Distribution Tax.

### 2. OBJECTIVES :

- (1) To bring Matching between accounting income to be reported and tax expenses to be charged.
- (2) Recognition of tax expense in P&L.

### 3. DIFFERENCE BETWEEN ACCOUNTING PROFIT AND TAX PROFIT:

There is a difference between accounting profit (i.e. Profit calculated on the basis of accounting policies) and taxable profit (i.e. profit calculated as per Income Tax laws). There are two main reasons for this difference.

1. **Timing difference:** These difference originate in one period and is capable of reversal in one or more subsequent periods. e.g.
  - \* Difference in rate of depreciation
  - \* Difference in method of depreciation
  - \* Section 43B items of the Income Tax Act (Outstanding Interest, Bonus, etc).
  - \* Provision for doubtful debts
  - \* Provision for warranties
  - \* Provision for decrease in value of assets
  - \* Provision for impairment of assets, etc.
2. **Permanent Difference:** These differences originate in one period and do not reverse subsequently e.g., expenses charged to profit & Loss but not allowed for tax purpose at all in any year or incomes credited to Profit & Loss but are exempt from tax.

### 4. TIMING DIFFERENCES:

Timing differences will lead to either Deferred Tax Asset or Deferred Tax Liability. When accounting profit is more than taxable profit, a deferred tax liability is created. However when accounting profit is less than taxable profit, a Deferred Tax Asset is created e.g.

- Accelerated depreciation allowed by Income Tax Act leads to creation of Deferred Tax Liability.
- Provision for doubtful debts will lead to creation of Deferred Tax Asset.

#### 5. PERMANENT DIFFERENCES :

Permanent differences are differences that always remain and are of permanent nature.

- Permanent differences do not create Deferred Tax Asset / Deferred Tax Liability.
- These are excluded for determining of tax expense.

#### 6. DIFFERENCE BETWEEN TAX EXPENSES AND CURRENT TAX :

The difference between tax expenses and current tax (i.e. Tax payable as per Income Tax Laws) arises only on account of timing difference which creates Deferred Tax Asset or Deferred Tax Liability

Tax expense = Current Tax + Deferred Tax

Current tax is calculated using tax rates and tax laws applicable for the relevant accounting year. Deferred Tax Assets or Deferred Tax Liability is determined using tax rate and tax laws that have been enacted or substantially enacted at the Balance Sheet date. Further deferred tax is not discounted to its P.V.

#### 7. RECOGNITION OF D.T.L AND D.T.A. :

Deferred Tax Liability must be provided for, but prudence would require that Deferred Tax Assets should be recognised and carried forward only to the extent that there is reasonable certainty that sufficient future taxable income will be available against which such Deferred Tax Asset can be realised. However in case of unabsorbed depreciation and carry forward losses under Income Tax laws, Deferred Tax Asset should be recognised only to the extent there is virtual certainty that sufficient future taxable income will be available against which such Deferred Tax Asset can be realised.

#### 8. REVIEW OF DEFERRED TAX ASSET:

The carrying amount of deferred tax asset should be reviewed at each balance sheet date, if it is evident that any portion of the deferred tax asset is not recoverable because of uncertainty of future income, the deferred tax asset should be written down. Any such written down amount may be reversed in subsequent period to the extent that it becomes reasonably certain that sufficient future taxable income will be available.

**9. RE - ASSESSMENT OF UNRECOGNIZED DEFERRED TAX ASSET:** Previously unrecognized deferred tax asset is re-assessed at every balance sheet date. If it becomes reasonably certain that such unrecognized deferred tax asset will be realised, then unrecognized deferred tax asset is recognised now.

Any adjustment arising out of such review / reassessment is charged / credited to Profit & loss account of the year. ( i.e. year of review / reassessment) It is not prior period item but a change in accounting estimate. However if the amount is material proper disclosure should be made because this item would be an item of exceptional nature.

**10. DISCLOSURE:**

- The break - up of deferred tax asset / liability should be disclosed.
- In case of deferred tax asset arising out of unabsorbed depreciation or loss, evidence-supporting recognition should be disclosed.
- Deferred tax asset / liability should be disclosed separately from current asset / liabilities. They should also be distinguished from advance tax / tax provision / tax refund due.
- Deferred tax asset and liability should be set off if permissible under the tax laws but to be shown separately if not permissible.

**CLASSWORK QUESTIONS**

**Question 1**

ABC Ltd. has provided depreciation as per accounting records ₹ 8,00,000 and as per tax records ₹ 14,00,000. Unamortised preliminary expenses, as per tax record is ₹ 10,000. There is adequate evidence of future profit sufficiency. How much deferred tax asset / liability should be recognized as transition adjustment. Tax rate is 30%.

**Question 3**

A company ABC Ltd. prepares its accounts annually on 31st March. The company has incurred a loss of ₹ 1,00,000 in the year 2003 and made profits of ₹ 50,000 and 60,000 in year 2004 and year 2005 respectively. It is assumed that under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 2003, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set-off. It is also assumed that there is not difference between taxable income and accounting income except that set-off of loss is allowed in years 2004 and 2005 for tax purposes.

**Question 4**

Omega Limited is working on different projects those are likely to be completed within 3 years period. It recognises revenue from these contracts on percentage of completion method for financial statement during 2006, 2007 and 2008 for ₹11,00,000, ₹ 16,00,000 and ₹ 21,00,000 respectively. However, for Income - tax purpose, it has adopted the completed contract method under which it has recognised revenue of ₹ 7,00,000, ₹ 18,00,000 and ₹ 23,00,000 for the years 2006, 2007 and 2008 respectively. Income - tax rate is 35%. Compute the amount of deferred tax asset / liability for the years 2006, 2007 and 2008.

**Question 5**

Dilemma Ltd. has operating profit before taxes and depreciation of ₹ 500 Lacs in each of the 3 years. The company purchased a microcomputer for ₹ 240 Lacs in the beginning of Year 1. The expenditure was fully allowed as a deduction U/s 35 of the Income - tax Act. However the company has decided to amortise the expense over its useful life of 3 years in its books.

The tax rates in the 3 years are :

Year 1      40%

Year 2 38%

Year 3 35%

Calculate Deferred Taxes if it is assumed that future tax rates are known only one year ahead, pass journal entries for all the three years.

**Question 6**

Sheetal Ltd. has provided the following information for the year ended 31st March, 2019:

Particulars	Amount (₹)
Accounting profit	9,00,000
Book profit as per MAT	5,25,000
Profit as per Income Tax Act	95,000
Tax rate	30%
MAT rate	7.5%

You are required to 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. (Nov'19)

**CLASSWORK SOLUTIONS**

**Answer 1**

i)	Debit - A/cs = 8,00,000	General Res.	
	Debit - Tax = 14,00,000	<del>P &amp; L</del>	1,80,000
		To DTL	1,80,000
	TD = 6,00,000		
	X Tax rate = 30%		
	DTL		<u>180,000</u>

ii) Unamortised Prelim

Exp. as per IT = 10,000	DTA	3000
(Timing diff)	To <del>P &amp; L</del>	3000

X Tax rate	30%	General Res
DTA	<u>3000</u>	

**Answer 2**

**Statement of Profit and Loss**

(for the three years ending 31st March, 20x1, 20x2, 20x3)

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

Answer 3

Calculation of Deferred Tax Asset/Liability

Year	Accounting Income	Taxable Income	Timing Difference (balance)	Deferred Tax Liability (balance)
2014 – 2015	11,00,000	7,00,000	4,00,000	1,40,000
2015 – 2016	16,00,00	18,00,000	2,00,000	70,000
2016 – 2017	21,00,000	23,00,000	NIL	NIL
	48,00,000	48,00,000		

As per AS 22, deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

Answer 4

1) P/L

(₹ in Lakhs)

	1	2	3
PBD & T	500	500	500
(-) Dept <sup>n</sup>	(80)	(80)	(80)
PBT (AI)	420	420	420
(-) Tax Exp			
CT	(104) → 40%		
(190)	(175)		
DT	(60.8) → 38%		
32.8	28		
PAT	255.2	262.8	273
∴ mc not fulfilled i.e. AI - Tax rate ≠ PAT			

2) TI & CT

	1	2	3
AI	420	420	420
(+) Dept <sup>n</sup> disallowed	80	80	80
(-) Dept <sup>n</sup> allowed	(240)		
TI	260	500	500
Tax rate	40%	38%	35%
CT	104	190	175

3) TD & it's Reversal

	1	2	3
Dept <sup>n</sup> - A/cs	80	80	80
Dept <sup>n</sup> - Tax	240	-	-
Op. bal. of TD	-	160	80
(+) TD ↑	160	-	-
(-) TD ↓	-	80	80
Clo. Bal. of TD	160	80	
Tax rate	40%	38%	35%

4) DTL & it's Reversal

	1	2	3
Op. bal. of DTL	-	60.8	28
(+) DTL ↑	60.8*	-	-
(-) DTL ↓	-	32.8*	28*
Clo. Bal. of DTL	60.8	28	-
	(160 × 38%)	(80 × 35%)	

Year 1

P & L 164.8

To CT 104

To DTL 60.8

Year 2

P & L 157.2

DTL 32.8

To CT 190

Year 3

P & L            147

DTL 28

To CT            175

**Answer 5**

Tax as per accounting profit     $9,00,000 \times 30\% = ₹ 2,70,000$

Tax as per Income-tax Profit     $95,000 \times 30\% = ₹ 28,500$

Tax as per MAT                     $5,25,000 \times 7.50\% = ₹ 39,375$

Tax expense = Current Tax + Deferred Tax

₹ 2,70,000 = ₹ 28,500 + Deferred tax

Deferred Tax liability as on 31-03-2019

= ₹ 2,70,000 – ₹ 28,500 = ₹ 2,41,500

Amount of tax to be debited in Profit and Loss account for the year 31-03-2019

Current Tax + Deferred Tax liability + Excess of MAT over current tax

= ₹ 28,500 + ₹ 2,41,500 + ₹ 10,875 (39,375 – 28,500)

= ₹ 2,80,875

## AS 24 - DISCONTINUING OPERATIONS

### 1. OBJECTIVES :

- (i) Reporting Information about discontinuing Operations:
- (ii) This will enhance the ability of users of Financial Statement to make Projections of an enterprises.
  - Cash Flows
  - Earning generating capacity
  - And
  - Financial Position

By segregating Information about discontinuing Operations from Information about Continuing Operations.

### 2. REPORTING :

- Separate Profit/Loss will be calculated for
  - Continuing Operations
  - Discontinuing Operations
- Separate Cash Flows will reported
- Separate Assets & Liabilities shall be reported

### 3. MEANING OF DISCONTINUING OPERATION :

- Discontinuing Operation should be single plan
  - To disposing off significant Assets and Liabilities  
Either by selling in Single transactions  
Or by Demerger  
Or by Spin off of ownership
  - To disposing off Assets and Liabilities in piecemeal (Individually)
  - To terminate through abandonment permanently without substantial Sale of Assets.
- Discontinuing Operation should be component/segment as per AS – 17. (i.e. Separate major line of business or geographical area of operation)
- Discontinuing Operation should be Distinguishable Component Financially and Operationally.

**E.g.** A company manufactures and sells 10 brands of consumer products that are grouped into five major product lines – beauty care, health care, food, pet care and baby care. Each brand comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, each brand is a component of the entity. Each product line (i.e., a group of components) represents a major line of business that comprises a major part of the entity's operations and financial results. The company decides to exit the beauty care market and disposes of its related product line.

**Ans.** The disposal qualifies as a discontinued operation because the beauty care product line is a group of components of the entity that represents a major line of business that comprises a major part of an entity's operations and financial results (i.e., a strategic shift).

#### 4. FOLLOWING MAY NOT BE CONSIDERED AS DISCONTINUING OPERATIONS:

A restructuring transactions or events that do not meet the definition of discontinuing operations as per AS – 24 should not be called as Discontinuing Operations.

- Gradual phasing out of a product line or class of service.
- Discontinuing, even if abruptly, Several Products within an ongoing line of business, doesn't necessary mean discontinuing Operations.
- Shifting of some marketing or production activities for a particular line of business from one location to another.
- Closing of a facility to achieve Productivity, Improvements or Cost Savings.
- Change in the Scope of Operations.
- Selling the subsidiary whose activities were similar to its holding Co.

#### 5. INITIAL DISCLOSURE EVENT:

Information about planned discontinuance must be disclosed in the First Set of Financial Statement immediately after the 'Initial Disclosure event'.

Initial Disclosure event is the event out of these two and whichever occurs earlier:

- **Entering into an agreement to sell** substantially all the assets of the discontinuing Operation.

Or

Resolution of Discounting Operations is **approved** in Board meeting and **announce**.

**CLASSWORK QUESTIONS**

**Question 1**

Qu Ltd. is in the business of manufacture of Passenger Cars and Commercial Vehicles. The Company is working on a strategic plan to shift from the Passenger Car segment 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 plan, it will reduce the production of Passenger Cars by 20% annually. It also plans to commence another New Factory for the manufacture of Commercial Vehicles and transfer surplus employees in a phased manner:

1. You are required of comment if mere gradual phasing out in itself can be considered as a "Discontinuing Operation" within the meaning of AS-24.
2. 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 factory, does this trigger the application of AS-24?
3. Would your answer to the above be different, if the Company resolves to sell the assets of the Passenger Car Division in a phased but time bound manner?

**Question 2**

Resource Enterprises produces a standard type of tools and equipments for industrial use. The company carry out its production into 3 processes. It has been found that over a period of a time cost of production of the first process is 15% higher than the market price of the intermediate product available freely in the market. The company has decided to close down the first process as a measure of cost saving. Should this event be treated as a discontinuing operations?

**Question 3**

A company has two divisions - cement and steel. It has started negotiating for disposal of the steel division informally since May 2008, discussion has been held with the possible buyers, the labour union has demonstrated against this secret deal, the company has given a statement that there is no move to sell the steel division. The significant reduction in the production has taken place because of decline in the market demand for the company's product not as planned strategy to close down operation. During November 2008 the Board of Directors has announced that they are considering disposal of the steel division because of continuing loss suffered by that division. But no formal resolution was passed. Necessary formalities for disposal of a division were fulfilled only during January 2009 and the steel division was disposed of in the last week of January 2009. The company follows calendar year as accounting year. Does this event require disclosure?

CLASSWORK SOLUTIONS

**Answer 1**

1. Mere gradual phasing out in itself cannot be considered as a Discontinuing Operation (DO). Gradual or evolutionary phasing out of a product line or class of service is not DO para 9
2. Passing of 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 factory, does not trigger the application of AS-24. It is sale in its entirety remember and not some of the assets. Also starting the operations in the New Factory is altogether a new business and has nothing to do with old business.
3. Resolution to sell assets of the Passenger Car Division in a phased but time bound manner will lead to identification of a Discontinuing Operation as per AS-24. It means there is a single plan to discontinue the operation. The manner of discontinuance seems to be piecemeal distribution.

**Answer 2**

The company has made a good decision of outsourcing the service, in respect of a single process. This has been done by the company with a view to achieve cost reduction. The change is merely a cost -saving endeavor. Such a change does not meet definition criteria in para 3 (a) of AS-24. Hence, this change is not discontinuing operation.

**Answer 3**

As per AS 24, Information about planned discontinuance must be disclosed in the first set of financial statement immediately after the initial disclosure event, An initial disclosure event is the event out of these two whichever occurs earlier:-

- Entering into an agreement to sell substantially all the assets of the discontinuing operation
- Approving and announcing of the discontinuance plan

In the given case the company is planning to discontinue the steel division. The directors have announced the plan of discontinuance, during November 2008 but the board resolution is not yet passed. As per the standard the initial disclosure event will take place when the discontinuance plan is approved and announced, since board resolution is not passed it can be said that approval of the plan is not yet made, so the initial disclosure does not take place in the year 2008 and hence no disclosure with regards to discontinuance of the Steel division is required. In the year 2009 the steel division is disposed hence disclosures would be given in the financial statements of the year 2009.

## AS 25 - INTERIM FINANCIAL REPORTING

### OBJECTIVE

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in a complete or condensed financial statements for an interim period.

### SCOPE

1. This Statement does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement.
2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator.
3. The requirements related to cash flow statement, complete or condensed, contained in this Statement are applicable where an enterprise prepares and presents a cash flow statement for the purpose of its annual financial report.

### DEFINITIONS

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

- 1) Interim period is a financial reporting period shorter than a full financial year.
- 2) Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Standard) for an interim period.

## CONTENT OF AN INTERIM FINANCIAL REPORT

A complete set of financial statements normally includes:

- balance sheet;
- statement of profit and loss;
- cash flow statement; and
- notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

## FORM AND CONTENT OF INTERIM FINANCIAL STATEMENTS

- 1) 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.
- 2) If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement
- 3) If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with Accounting Standard (AS) 20, Earnings Per Share, basic and diluted earnings per share should be presented in accordance with AS 20 on the face of the statement of profit and loss, complete or condensed, for an interim period.
- 4) If an enterprise's annual financial report included the consolidated financial statements in addition to the parent's separate financial statements, the interim financial report includes both the consolidated financial statements and separate financial statements, complete or condensed.

### Explanatory Notes:

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

- (a) a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change;
- (b) explanatory comments about the seasonality of interim operations;
- (c) the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.

- (d) the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;
- (e) issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares;
- (f) dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares;
- (g) segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements);
- (h) material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period;
- (i) the effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations; and
- (j) material changes in contingent liabilities since the last annual balance sheet date.

#### Periods for which Interim Financial Statements are required to be presented:

- 1) Interim reports should include interim financial statements (condensed or complete) for periods as follows:
  - 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;
  - 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;
  - 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.
- 2) For an enterprise whose business is highly seasonal, financial information for the twelve months ending on the interim reporting date and comparative information for the prior twelve-month period may be useful.

### MATERIALITY

In deciding how to recognize, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognized that interim measurements may rely on estimates to a greater extent than measurements of annual financial.

### DISCLOSURE

An enterprise may not prepare and present a separate financial report for the final interim period because the annual financial statements are presented.

If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

ILLUSTRATION QUESTION

**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 ₹ 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	(₹ 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	₹ 200 crores
2nd quarter ending on 31st March, 20X1	₹ 200 crores
3rd quarter ending on 30th June, 20X1	₹ 200 crores
4th quarter ending on 30th September, 20X1	₹ 200 crores
Total	₹ 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 × 20%	₹ 40 lakhs
2nd quarter ending on 31st March, 20X1	200 × 20%	₹ 40 lakhs
3rd quarter ending on 30th June, 20X1	200 × 30%	₹ 60 lakhs
4th quarter ending on 30th September, 20X1	200 × 30%	₹ 60 lakhs

**Illustration 3**

Accountants of Poornima Ltd. showed a net profit of ₹ 7,20,000 for the third quarter of 20X1 after incorporating the following:

- (i) Bad debts of ₹ 40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.
- (ii) Extra ordinary loss of ₹ 35,000 incurred during the quarter has been fully recognized in this quarter.
- (iii) Additional depreciation of ₹ 45,000 resulting from the change in the method of charge of depreciation assuming that ₹ 45,000 is the charge for the 3rd quarter only.

Ascertain the correct quarterly income.

**Solution**

In the above case, the quarterly income has not been correctly stated. As per AS 25 “Interim Financial Reporting”, the quarterly income should be adjusted and restated as follows:

Bad debts of ₹ 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) ₹ 20,000 to the next quarter. Therefore, ₹ 20,000 should be deducted

from ₹ 7,20,000. The treatment of extra-ordinary loss of ₹ 35,000 being recognized in the same quarter is correct.

Recognising additional depreciation of ₹ 45,000 in the same quarter is in tune with AS 25. Hence no adjustments are required for these two items.

Poornima Ltd should report quarterly income as ₹ 7,00,000 (₹ 7,20,000 – ₹ 20,000).

#### Illustration 4

Intelligent Corporation (I Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:

Quarter I	II	III	IV
Ending 30th June 15%	30th September 15%	31st December 50%	31st March 25%

For the First quarter ending 30th June, 20X1, I-Corp. gives you the following information:

	₹ crores
Sales	50
Salary and other expenses	30
Advertisement expenses (routine)	02
Administrative and selling expenses	08

While preparing interim financial report for the first quarter, 'I-Corp.' wants to defer ₹ 21 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore, third quarter should be debited by higher expenditure, considering the seasonal nature of business 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

		(₹ 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)	<u>10</u>	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 ₹ 21 crores is not tenable as expenditures are uniform throughout all quarters.

**THEORETICAL QUESTIONS**

**Question 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.

**Solution**

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).

**Question 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?

**Solution**

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.

**Question 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?

**Solution**

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.

PRACTICAL QUESTIONS

**Question 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?

**Solution**

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.

**Question 9**

On 30th June, 20X1, Asmitha Ltd. incurred ₹ 2,00,000, net loss from disposal of a business segment. Also, on 31st July, 20X1, the company paid ₹ 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.

**Solution**

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 ₹ 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 ₹ 60,000 Property tax payment relates to entire calendar year 20X1, ₹ 30,000 would be reported as an expense for six months ended on 30th September, 20X1 while out of the remaining ₹ 30,000, ₹ 15,000 for January, 20X1 to March, 20X1 should be shown as payment of the outstanding amount of previous year and another ₹ 15,000 related to quarter October, 20X1 to December, 20X1 would be reported as prepaid expenses.

**Question 10**

An enterprise reports quarterly, estimates an annual income of ₹ 10 lakhs. Assume tax rates on 1st ₹ 5,00,000 at 30% and on the balance income at 40%. The estimated quarterly income are ₹ 75,000, ₹ 2,50,000, ₹ 3,75,000 and ₹ 3,00,000.

Calculate the tax expense to be recognized in each quarter.

**Solution**

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.

	₹
Estimated Annual Income (A)	10,00,000
Tax expense:	
30% on ₹ 5,00,000	1,50,000
40% on remaining ₹ 5,00,000	2,00,000
(B)	3,50,000

$$\text{Weighted average annual income tax rate} = \frac{B}{A} = \frac{3,50,000}{10,00,000} = 35\%$$

Tax expense to be recognized in each of the quarterly reports	₹
Quarter I - ₹ 75,000 × 35%	26,250
Quarter II - ₹ 2,50,000 × 35%	87,500
Quarter III - ₹ 3,75,000 × 35%	1,31,250
Quarter IV - ₹ 3,00,000 × 35%	1,05,000
₹ 10,00,000	3,50,000

**Question 11**

Antarbarti Limited reported a Profit Before Tax (PBT) of ₹ 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 ₹ 4 lakhs received during the quarter has been recognized to the extent of ₹ 1 lakh only.
- (ii) 80% of sales promotion expenses ₹ 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 ₹ 12 lakhs. The entire amount has been debited in the third quarter, though the share of the third quarter is only ₹ 3 lakhs.

- (iv) ₹ 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 ₹ 3 lakhs. Out of this loss ₹ 1 lakh relates to previous quarters.
- (vi) Sale of investment in the first quarter resulted in a gain of ₹ 20 lakhs. The company had apportioned this equally to the four quarters.

Prepare the adjusted profit before tax for the third quarter.

**Solution**

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**

	( ₹ in lakhs)
Profit before tax (as reported)	4
Add: Dividend income ₹ (4-1) lakhs	3
Excess depreciation charged in the 3rd quarter, due to change in the method	-
Extra ordinary gain ₹ (2-1) lakhs	1
Cumulative loss due to change in the method of inventory valuation should be applied retrospectively ₹ (3-2) lakhs	1
	9
Less: Sales promotion expenses (80% of ₹ 15 lakhs)	(12)
Gain on sale of investment (occasional gain should not be deferred)	(5)
Adjusted Profit before tax for the third quarter	(8)

## AS 26 - INTANGIBLE ASSETS

### 1. OBJECTIVE :

AS 26 prescribes recognition criteria, measurement, amortization & disclosure of IAs

### 2. DEFINITION OF ASSET :

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

### 3. DEFINITION OF INTANGIBLE ASSETS :

An IA is an identifiable, non-monetary asset without physical substance held for use in the production or supplying of goods or services, or for rentals to others or for administrative purposes.

### 4. AS 26 IS APPLICABLE TO :

- (a) Goodwill
- (b) Advertising exps
- (c) Preliminary exps
- (d) R & D costs
- (e) Patents, trademarks & copyrights
- (f) Computer software etc

### 5. RECOGNITION CRITERIA :

An IA will be recognized i.e. recorded in the books provided both the following conditions are fulfilled :

- (a) Probable future economic benefits will flow from the IA to the enterprise &
- (b) The cost of the IAs can be reliably measured

### 6. COST OF INTANGIBLE ASSETS :

The cost of IA depends on the way it is acquired :

- (a) Separate Acquisition
- (b) Exchange for another asset
- (c) Issue of shares or securities

- (d) IAs arising from amalgamation (in the nature of purchase)
- (e) Acquisition through government grants
- (f) Self generated IAs

**7. SUBSEQUENT EXPENDITURE ON IA :**

Expenditure incurred on IAs after they have been recognized / recorded is called subsequent expenditure. It should be added to the cost of IA only if such subsequent expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance & the expenditure can be measured & attributed to the asset reliably.

**8. CARRYING AMOUNT OF IA :**

It is the amount at which assets are recognized in the Balance Sheet, net of accumulated amortization & impairment losses thereon

**9. AMORTIZATION METHOD :**

The depreciable amount of IAs is amortised over its useful life. Depreciable amount is cost less residual value. AS 26 provides that amortisation method should reflect the pattern in which the asset's economic benefits are consumed. If that is not determinable then SLM should be used. The residual value of IAs is assumed to be zero unless :

- (a) There is commitment by a third party to purchase the asset at the end of its useful life or
- (b) There is an active market for the asset that can be used to determine the residual value & that such a market would probably exist at the end of the asset's useful life. The residual value cannot be subsequently increase for changes in value (decrease is permitted).

The useful life of the IAs should be taken as 10 years unless there is clear evidence that the useful life is longer than 10 years. If economic benefits from IAs are achieved through legal right granted for finite period then the useful life cannot exceed the legal right period unless the legal right is renewable & the renewal is certain.

**10. REVIEW OF AMORTISATION METHOD :**

Amortisation method should be review annually. It should be changed if :

- (a) The expected useful life has significantly changed or
- (b) The pattern of future economic benefits has significantly changed.

Prospective / retrospective effect would depend upon whether it is a change in accounting estimate / policy.

#### 11. DE-RECOGNITION OF INTANGIBLE ASSET :

An IA should be de-recognised / eliminated from Balance Sheet if :

- (a) It is disposed or
- (b) No future economic benefits are expected from its use.

Gain / loss on disposal should be recognized as income / expense in the P & L A/c.

#### 12. INTERNALLY GENERATED GOODWILL :

Internally generated goodwill is not recognized in the financial statements because the cost cannot be reliably measured.

#### 13. RESEARCH & DEVELOPMENT EXPENSE :

Research is original & planned investigation undertaken with the prospect of gaining new scientific or technical knowledge & understanding. 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, process systems or services prior to the commencement of commercial production or use. If an enterprise cannot distinguish the research phase from the development phase of a project to create an intangible asset, it should treat the expenditure on that project as if it were incurred in the research phase only. As per AS 26, research cost must be expensed when it is incurred i.e. research cost cannot be capitalized. Development costs are also to be expensed unless they meet the asset recognition criteria & the enterprise can demonstrate the following :

- (a) Technical feasibility of completing the IA so that it will be available for use or sale.
- (b) Its intention to complete the IA & its intention & ability to use or sell it etc..

➤ Cost of internally generated intangible would comprise of the costs which are incurred during the development phase of the IA & which are directly attributable to or reasonably allocable to the IA.

#### 14. AS 26 IS NOT APPLICABLE TO :

- (a) Ownership interest in other enterprise, investments
- (b) Goodwill arising on amalgamation
- (c) Goodwill arising on consolidation

- (d) DTA
- (e) Issue exps, discounts & premiums on borrowings & issue of shares etc.

**15. DISCLOSURES :**

The financial statements should disclose the following in respect of IA :

- (a) Useful life or amortisation rate
- (b) Amortisation method
- (c) Gross carrying amount & accumulated amortisation at the beginning & end of the period
- (d) Reconciliation of carrying amount at the beginning & end of the period
- (e) If amortisation period is more than 10 years, the reason thereof
- (f) R & D exps recognized as expenses during the period etc..

**CLASSWORK QUESTIONS**

**Question 1**

A Company had deferred research and development cost of ₹ 150 lakhs. Sales expected in the subsequent years are as under:

Years	Sales (₹ in lakhs)
I	400
II	300
III	200
IV	100

You are asked to suggest how should Research and Development cost be charged to Profit and Loss account. If at the end of the III year, it is felt that no further benefit will accrue in the IV year, how the unamortised expenditure would be dealt with in the accounts of the Company?

**Question 2**

NDA Corporation is engaged in research on new process design for its product.

It had incurred an expenditure of ₹ 530 Lakhs on research upto 31st March, 2010.

The Development of the process began on 1st April, 2010 and development phase expenditure was ₹ 360 lakhs upto 31st March 2011 which meets assets recognition criteria.

From 1st April 2011 the company will implement the new process design which will result in after tax saving of ₹ 80 Lakhs per annum for the next five years.

The cost of capital of company is 10%

**Explain:**

- (i) Accounting treatment for research expenses.
- (ii) The cost of internally generated intangible asset “as per AS 26”.
- (iii) The amount of amortization of assets.

(The present value of annuity factor of ₹ 1 for 5 Years @ 10% 3.7908)

**Question 3**

M Ltd. launched a project for producing product A in Nov. 2008. The company incurred ₹ 30 lakhs towards Research and Development expenses upto 31st March, 2010. Due to unfavourable market conditions the management feels that it is not possible to manufacture and sell the product in the market for next so many years.

The management hence wants to defer the expenditure write off to future years.

Advise the company as per the applicable Accounting Standard.

CLASSWORK SOLUTIONS

Answer 1

(i) Based on sales, research and development cost to be allocated as follows:

Year	Research and Development cost allocation (₹ in lakhs)
I	$\frac{400}{1,000} \times 150 = 60$
II	$\frac{300}{1,000} \times 150 = 45$
III	$\frac{200}{1,000} \times 150 = 30$
IV	$\frac{100}{1,000} \times 150 = 15$

(ii) If at the end of the III year, the circumstances do not justify that further benefit will accrue in IV year, then the company has to charge the unamortised amount i.e. remaining ₹45 lakhs [150 – (60 + 45)] as an expense immediately.

As per AS 26 on Intangible Assets, expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. It has been assumed in the above solution that the entire cost of ₹150 lakhs is development cost.

Answer 2

(1) Research Expenditure – According to para 41 of AS 26 ‘Intangible Assets’, the expenditure on research of new process design for its product ₹530 lakhs should be charged to Profit and Loss Account in the year in which it is incurred.

(2) Cost of internally generated intangible asset – The question states that the development phase expenditure amounting ₹360 lakhs incurred upto 31st March, 2011 meets asset recognition criteria. As per AS 26 for measurement of such internally generated intangible asset, fair value can be estimated by discounting estimated future net cash flows.

Savings (after tax) from implementation of new design for next 5 years	80 lakhs p.a.
Company's cost of capital	10%
Annuity factor @10% for 5 years	3.7908
Present value of net cash flows (₹80 lakhs × 3.7908)	303.26 lakhs

The cost of an internally generated intangible asset would be lower of cost value ₹360 lakhs or present value of future net cash flows ₹303.26 lakhs. Hence, cost of an internally generated intangible asset will be ₹ 303.26 lakhs. The difference of ₹56.74 lakhs (i.e. ₹ 360 lakhs - ₹ 303.26 lakhs) will be amortized by the enterprise for the financial year 2010.11

- (3) Amortisation - The company can amortise ₹ 303.26 lakhs over a period of five years by charging ₹60.65 lakhs per annum from the financial year 2011-12 onwards.

### Answer 3

As per AS 26 'Intangible Assets', the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimates 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. Amortization should commence when the asset is available for use.

Base Limited has been following the policy of amortization of the intangible asset over a period of 12 years on straight line basis. The period of 12 years is more than the maximum period of 10 years specified as per AS 26.

Accordingly, carrying amount of ₹ 84 lakhs would be amortized over remaining 7 years by ₹12 lakhs per year.

## AS 28 - IMPAIRMENT OF ASSETS

### Objective

The objective of this Standard 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.

### Scope

This Standard should be applied in accounting for the impairment of all assets, other than:

- inventories (see AS 2, Valuation of Inventories);
- assets arising from construction contracts (see AS 7, Construction Contracts);
- financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and
- deferred tax assets (see AS 22, Accounting for Taxes on Income).

### Definitions

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

- 1) **Recoverable amount** is the higher of an asset's net selling price and its value in use.
- 2) **Value in use** is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.
- 3) **Net selling price** is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
- 4) **Costs of disposal** are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.
- 5) **An impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- 6) **Carrying amount** is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

- 7) **Depreciation (Amortisation)** is a systematic allocation of the depreciable amount of an asset over its useful life.
- 8) **Depreciable amount** is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.
- 9) **Useful life is either:**
  - the period of time over which an asset is expected to be used by the enterprise; or
  - the number of production or similar units expected to be obtained from the asset by the enterprise.
- 10) **A cash-generating unit** is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.
- 11) **Corporate assets** are assets other than goodwill that contribute to the future cash flows of both the cash generating unit under review and other cash generating units.
- 12) **An active market** is a market where all the following conditions exist :
  - the items traded within the market are homogeneous;
  - willing buyers and sellers can normally be found at any time; and
  - prices are available to the public.

### Identifying an Asset that may be Impaired

An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit. An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset.

In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

### External sources of information

- (a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use;
- (b) significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated;
- (c) market interest rates or other market rates of return on investments have increased

during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially;

- (d) the carrying amount of the net assets of the reporting enterprise is more than its market capitalization;

#### Internal sources of information

- (e) evidence is available of obsolescence or physical damage of an asset;
- (f) significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date; and
- (g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

#### Recognition and Measurement of an Impairment Loss

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. That reduction is an impairment loss.

An impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard.

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 recognized 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.

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.

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.

If an impairment loss is recognized, any related deferred tax assets or liabilities are determined under Accounting Standard (AS) 22, Accounting for Taxes on Income.

### IDENTIFICATION OF THE CASH-GENERATING UNIT TO WHICH AN ASSET BELONGS

A cash generating unit is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset, if it is not possible to estimate the recoverable amount of the individual asset because the value in use of the asset cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the asset belongs.

If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise, this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets.

In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output.

Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

#### Example 1

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

It is not possible to estimate the recoverable amount of the private railway because the value in use of the private railway cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the private railway belongs, that is, the mine as a whole.

### Example 2

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Since the enterprise does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The cash-generating unit for each route is the bus company as a whole.

If an active market exists for the output produced by an asset or a group of assets, this asset or group of assets should be identified as a separate cash-generating unit, even if some or all of the output is used internally.

### Example 3

A machine has suffered physical damage but is still working, although not as well as it used to. The net selling price of the machine is less than its carrying amount.

The machine does not generate independent cash inflows from continuing use.

The smallest identifiable group of assets that includes the machine and generates cash inflows from continuing use that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

**Assumption 1:** Budgets/forecasts approved by management reflect no commitment of management to replace the machine.

The recoverable amount of the machine alone cannot be estimated since the machine's value in use:

(a) may differ from its net selling price; and

(b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

The production line is not impaired, therefore, no impairment loss is recognised for the machine. Nevertheless, the enterprise may need to reassess the depreciation period or the depreciation method for the machine. Perhaps, a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are consumed by the enterprise.

**Assumption 2:** Budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future.

Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

The machine's value in use can be estimated to be close to its net selling price. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (the production line). Since the machine's net selling price is less than its carrying amount, an impairment loss is recognised for the machine.

### RECOVERABLE AMOUNT AND CARRYING AMOUNT OF A CASH-GENERATING UNIT

The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined i.e., carrying amount is the summation of the carrying amount of all the assets grouped under one cash-generating unit. This also includes the liability only if that liability is necessary to be considered to determine the recovery amount. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit or

liabilities that have already been recognised in the financial statements. In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

### **GOODWILL**

Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs.

This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognized.

If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test.

### **IMPAIRMENT LOSS FOR A CASH- GENERATING UNIT ( including Goodwill)**

The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

- a. First, to goodwill allocated to the cash-generating unit (if any); and
- b. Then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets

The carrying amount of an asset should not be reduced below the highest of:

- a. Its net selling price (if determinable);
- b. Its value in use (if determinable); and
- c. Zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

After the requirements of impairment loss have been applied, a liability should be recognised for any remaining amount of an impairment loss for a cash-generating unit if that is required by another Accounting Standard.

### CORPORATE ASSETS

Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

**Examples-** Building of a headquarter or a division of the enterprise, EDP equipment or a research Centre.

In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review.

For each identified corporate asset:

- a. If the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and
- b. If the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom-up' and 'top-down' tests.

### REVERSAL OF AN IMPAIRMENT LOSS

An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset.

An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

## REVERSAL OF AN IMPAIRMENT LOSS FOR AN INDIVIDUAL ASSET

### Case I:

If impairment loss was written off to profit and loss account, then the reversal of impairment loss should be recognized as income in the financial statement immediately.

### Case II:

If impairment loss was adjusted with the Revaluation Reserve; then reversal of impairment loss will be written back to the reserve account to the extent it was adjusted, any surplus will be recognised as revenue. But in any case the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods. This is mainly because any further increase in value of asset is revaluation, which is governed by AS 10.

Depreciation impact post reversal of impairment loss:

After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

## REVERSAL OF AN IMPAIRMENT LOSS FOR A CASH-GENERATING UNIT

A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

- a. First, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and
- b. Then, to goodwill allocated to the cash-generating unit (if any),

In allocating a reversal of an impairment loss for a cash generating unit under paragraph 106, the carrying amount of an asset should not be increased above the lower of:

- (a) its recoverable amount (if determinable); and

- (b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

### REVERSAL OF AN IMPAIRMENT LOSS FOR GOODWILL

This Statement does not permit an impairment loss to be reversed for goodwill because of a change in estimates (for example, a change in the discount rate or in the amount and timing of future cash flows of the cash generating unit to which goodwill relates), an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

- a. The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and
- b. Subsequent external events have occurred that reverse the effect of that event.

### IMPAIRMENT IN CASE OF DISCONTINUING OPERATIONS

The approval and announcement of a plan for discontinuance is an indication that the assets attributable to the discontinuing operation may be impaired or that an impairment loss previously recognised for those assets should be increased or reversed.

In applying this Statement to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit.

#### For example:

- a. If the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation.  
Therefore, recoverable amount is determined for the discontinuing operation

as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Statement;

- b. If the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and
- C. If the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

After announcement of a plan, negotiations with potential purchasers of the discontinuing operation or actual binding sale agreements may indicate that the assets of the discontinuing operation may be further impaired or that impairment losses recognised for these assets in prior periods may have decreased.

ILLUSTRATION QUESTION

**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 (₹ in lakhs)
20X2	4000
20X3	6000
20X4	6000
20X5	8000
20X6	4000
Residual value at the end of 20X6	= ₹ 1000 lakhs
Property, Plant and Equipment purchased on 1-1-20XX	= ₹ 40,000 lakhs
Useful life	= 8 years
Net selling price on 31-12-20X1	= ₹ 20,000 lakhs

Calculate on 31-12-20X1:

- Carrying amount at the end of 20X1
- Value in use on 31-12-20X1
- Recoverable amount on 31-12-20X1
- Impairment loss to be recognized for the year ended 31-12-20X1
- Revised carrying amount
- Depreciation charge for 20X2.

**Note:** The year 20XX is the immediate preceding year before the year 20X0.

**Solution 1**

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
			<u>19,025</u>

**(a) Calculation of carrying amount:**

Original cost = ₹ 40,000 lakhs

Depreciation for 3 years =  $[(40,000 - 1000) \times 3/8] = ₹ 14,625$  lakhs

Carrying amount on 31-12-20X1 =  $[40,000 - 14,625] = ₹ 25,375$  lakhs

**(b) Value in use = ₹ 19,025 lakhs**

**(c) Recoverable amount = higher of value in use and net selling price i.e.**

₹ 20,000 lakhs.

**Recoverable amount = ₹ 20,000 lakhs**

**(d) Impairment Loss = ₹ (25,375 - 20,000) = ₹ 5,375 lakhs**

**(e) Revised carrying amount = ₹ (25,375 - 5,375) = ₹ 20,000 lakhs**

**(f) Depreciation charge for 20X2 =  $(20,000 - 1000)/5 = ₹ 3,800$  lakhs**

**Illustration 2**

X Ltd. is having a plant (asset) carrying amount of which is ₹ 100 lakhs on 31.3.20X1.

Its balance useful life is 5 years and residual value at the end of 5 years is ₹ 5 lakhs.

Estimated future cash flow from using the plant in next 5 years are:

For the year ended on	Estimated cash flow (₹ in lakhs)
31.3.20X2	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 ₹ 60 lakhs.

**Solution 2**

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 = $5 \times 0.620$			3.10
Present value of estimated cash flow by use of an asset and residual value, which is called “value in use”.			121.92

If net selling price of plant on 31.3.20X1 is ₹ 60 lakhs, the recoverable amount will be higher of ₹ 121.92 lakhs (value in use) and ₹ 60 lakhs (net selling price), hence recoverable amount is ₹ 121.92 lakhs.

**Illustration 3**

G Ltd., acquired a machine on 1st April, 20X0 for ₹ 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 ₹ 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 ₹ 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 3**

**Statement Showing Impairment Loss**

	(` 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)	<u>2.10</u>
Carrying amount of the machine as on 1st April, 20X4 (revalued)	5.10
Less: Depreciation for 2 years i.e. 20X4-20X5 & 20X5-20X6 $\left[ \frac{5.10 \text{ Crores}}{3 \text{ Years}} \times 2 \text{ Years} \right]$	(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 = $[(1.70 - 1.00) \times 2 \text{ years}]$	<u>(1.40)</u>
Impairment loss set off against revaluation reserve balance as per para 58 of AS 28 "Impairment of Assets"	<u>(0.70)</u>
Impairment Loss to be debited to profit and loss account	<u>0.21</u>

#### Illustration 4

X Ltd. purchased a Property, Plant and Equipment four years ago for ₹ 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 ₹ 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 ₹67.50 lakhs and expected disposal costs are ₹ 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 ₹ 60 lakhs?

#### Solution 4

##### 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 ₹ 64.50 lakhs (₹ 67.50 lakhs – ₹ 3 lakhs) and value in use is ₹ 60 lakhs. Therefore, recoverable amount will be ₹ 64.50 lakhs. Impairment loss will be calculated as ₹ 10.50 lakhs [₹ 75 lakhs (Carrying Amount after revaluation - Refer Working Note) less ₹ 64.50 lakhs (Recoverable Amount)].

Thus impairment loss of ₹ 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

	( ` 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

**Reference:** The students are advised to refer the full text of AS 28 “Impairment of Assets” (issued 2002).

THEORETICAL QUESTIONS

**Question 5**

Write short note on impairment of asset and its application to inventory.

**Solution 5**

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  $\leq$  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.

PRACTICAL QUESTIONS

**Question 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?

**Solution 6**

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.

**Question 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 ₹ 6,00,000. The estimated cost of destroying the asset is ₹ 70,000. How is the asset to be accounted for?

**Solution 7**

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 ₹ 70,000)]. Thus impairment loss will be calculated as ₹ 6,00,000 [carrying amount (₹ 6,00,000) –

recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss of ₹ 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 ₹ 70,000 as per AS 10 & 29.

### Question 8

Venus Ltd. has a fixed asset, which is carried in the Balance Sheet on 31.3.20X1 at ₹ 500 lakhs. As at that date the value in use is ₹ 400 lakhs and the net selling price is ₹ 375 lakhs.

From the above data:

- Calculate impairment loss.
- Prepare journal entries for adjustment of impairment loss.
- Show, how impairment loss will be shown in the Balance Sheet.

### Solution 8

- Recoverable amount is higher of value in use ₹ 400 lakhs and net selling price ₹ 375 lakhs.

Recoverable amount = ₹ 400 lakhs

Impairment loss = Carried Amount – Recoverable amount

= ₹ 500 lakhs – ₹ 400 lakhs = ₹ 100 lakhs.

	Particulars	Dr. Amount (₹ in lakhs)	Cr. Amount (₹ in lakhs)
(i)	Impairment loss account Dr. To Provision for Accumulated Impairment Loss Account (Being the entry for accounting impairment loss)	100	100
(ii)	Profit and loss account Dr. To Impairment loss (Being the entry to transfer impairment loss to profit and loss account)	100	100

- Balance Sheet of Venus Ltd. as on 31.3.20X1

	(₹ in lakhs)
Fixed Asset	
Asset less depreciation	500
Less: Impairment loss	(100)
	400

**Question 9**

Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 20X1 for ₹ 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 ₹ 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 ₹ 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 ₹ 54 crore per annum and has a carrying amount of ₹ 3.46 crore. All such machines put together could fetch a sum of ₹ 4.44 crore if disposed. Discuss the applicability of Impairment loss.

**Solution 9**

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.

**Question 10**

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	₹ 56 lakhs
Useful life period	10 years
Salvage value	Nil
Current carrying value	₹ 27.30 lakhs
Useful life remaining	3 years
Recoverable amount	₹ 12 lakhs
Upward revaluation done in last year	₹ 14 lakhs

**Solution 10**

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	₹
Current carrying amount (including revaluation amount of ₹ 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 ₹ 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 ₹ 4,00,000.

**Question 11**

A plant was acquired 15 years ago at a cost of ₹ 5 crores. Its accumulated depreciation as at 31st March, 20X1 was ₹ 4.15 crores. Depreciation estimated for the financial year 20X1-20X2 is ₹ 25 lakhs. Estimated Net Selling Price as on 31st March, 20X1 was ₹ 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 ₹ 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 ₹ 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 ₹ 2 lakhs to dispose of the plant, what would be your response to questions (i) and (ii) above?

**Solution 11**

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 ₹ 24.5 lakhs on 31.3.20X2 according to the provisions of AS 28 [Refer working note].

	(₹ 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 [₹ 60 lakhs – ₹ 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 (₹ 35.50 lakhs – ₹ 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) (₹ 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**

	(₹ in lakhs)
Opening book value as on 1.4.20X1 (₹ 500 lakhs – ₹415 lakhs)	85
Less: Depreciation for financial year 20X1–20X2	<u>(25)</u>
Closing book value as on 31.3.20X2	<u>60</u>
Estimated net selling price as on 1.4.20X1	30
Less: Estimated decrease during the year (20% of ₹ 30 lakhs)	<u>(6)</u>
Estimated net selling price as on 31.3.20X2	<u>24</u>
Estimated value in use as on 1.4.20X1	35.0
Less: Estimated decrease during the year (30% of ₹ 35 lakhs)	<u>(10.5)</u>
Estimated value in use as on 31.3.20X2	<u>24.5</u>

## AS 29 - PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

### 1. SCOPE:

**THIS ACCOUNTING STANDARD COVERS THE FOLLOWING AREAS :**

- PROVISIONS
- CONTINGENT LIABILITIES
- CONTINGENT ASSETS

### 2. PROVISIONS :

#### (a) DEFINITION OF PROVISION :

A provision is a liability which can be measured only by using a substantial degree of estimation.

#### (b) RECOGNITION OF PROVISION :

- 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 &
- A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognized. The amount of provision should be recognized before tax & is not discounted to its PV.

#### (c) NO PROVISION FOR FUTURE EXPENDITURE :

Financial statements deal with the financial position of an enterprise at the end of its reporting period & not its possible position in the future. Therefore, no provision is recognized for costs that need to be incurred to operate in the future. The only liabilities recognized in an enterprise's B/S are those that exist at the B/S date. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognized as provisions.

#### (d) REVIEW OF PROVISION :

Provisions should be reviewed at each Balance Sheet date & adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources

embodying economic benefits will be required to settle the obligation, the provision should be reversed.

**(e) REIMBURSEMENT :**

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized, when & only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognized for the reimbursement should not exceed the amount of the provision. In the statement of the P & L, the expense relating to a provision may be presented net of the amount recognized for a reimbursement.

**(f) OBLIGATING EVENT :**

An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation. Thus, a past event that leads to a present obligation is called an obligating event. Where there are a number of similar obligations (e.g. : product warranties), the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

**3. CONTINGENT LIABILITIES :**

**(a) DEFINITION :**

- A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- A CONTINGENT LIABILITY IS:
  - (i) A possible obligation that arises from past events & the existence of which be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise or
  - (ii) A present obligation that arises from past events but is not recognized because:
    - (1) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or
    - (2) a reliable estimate of the amount of obligation cannot be made

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

**(b) TREATMENT OF CONTINGENT LIABILITY :**

An enterprise should not recognize a contingent liability. A contingent liability is to be disclosed unless the possibility of an outflow of resources embodying economic benefits is remote. When an enterprise is jointly & severally liable for an obligation, that part of the obligation which is expected to be met by other parties is treated as a contingent liability. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources economic benefits has become probable.

**4. CONTINGENT ASSETS :**

**(a) DEFINITION :**

A contingent asset is a possible asset that arises from past events, the existence of which will be confirmed only by the occurrence or non-occurrence of 1 or more uncertain future events not wholly within the control of the enterprise.

**(b) TEREMENT OF CONTINGENT ASSETS :**

An enterprise should not recognize a contingent asset. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

**E.g.:** a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain. Where an inflow of economic benefits is probable, the contingent asset is usually disclosed in the Directors' Report & not in the financial statements. Contingent assets are assessed continually & if it has become virtually certain that an inflow of economic benefits will arise, the asset & the related income are recognized in the financial statements of the period in which the change occurs.

**CLASSWORK QUESTIONS**

**Question 1**

At the end of the financial year ending on 31st December, 2017, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

Probability Loss (₹)		
In respect of five cases (Win)	100%	
Next ten cases (Win)	60%	-
Lose (Low damages)	30%	1,20,000
Lose (High damages)	10%	2,00,000
Remaining five cases		
Win	50%	-
Lose (Low damages)	30%	1,00,000
Lose (High damages)	20%	2,10,000

Outcome of each case is to be taken. as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

**Question 2**

Venu Ltd sold 1 Lakh Vacuum pumps during the Year with a warranty condition to make good by repair / replacement any manufacturing defects reported within six months from the date of sale. Past experience in this regard showed that there were no replacement carried out but minor / major repairs were necessitated to the extent of 10% / 5% respectively of the units sold. The cost of such minor/major repairs would amount to ₹ 1,000 / ₹ 6,000 respectively. While finalizing the accounts for the Year, the company does not reflect any provision in this regard. Comment

**Question 3**

An engineering goods Company provides after- sales warranty for 2 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 invoice as under-

Invoice Date	Amount (₹)
19.01.2011	40,000
29.01.2012	25,000
15.10.2012	90,000

Calculate the Provision to be made for warranty under AS- 29 as at 31.03.2012 and 31.03.2013. Also compute amount to be debited to profit and Loss Account for the Year ended 31.03.2013.

#### Question 4

Shyam Ltd. (a Public Sector Company) provides consultancy and engineering services to its clients. In the year 2010-11, the Government has set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2006 based on the recommendations of the commission. The company makes the provision of ₹ 680 lakhs for pay revision in the financial year 2010-11 on the estimated basis as the report of the commission is yet to come. As per the contracts with the client on cost plus job, the billing is done on the actual payment made to the employees and allocated to jobs based on hours booked by these employees on each job.

The company discloses through notes to accounts:

“Salaries and benefits include the provision of ₹ 680 lakhs in respect of pay revision. The amount chargeable from reimbursable jobs will be billed as per the contract when the actual payment is made”.

The accountant feels that the company should also book/recognise the income by ₹ 680 lakhs in Profit and Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit. Comment on the opinion of the Accountant with reference to relevant accounting standards.

CLASSWORK SOLUTION

**Answer 1**

According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

- (i) There is a present obligation arising out of past events but not recognized as provision.
- (ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- (iii) The possibility of an outflow of resources embodying economic benefits is also less likely to occur.
- (iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise.

The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable.

As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made.

For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

$$\begin{aligned}\text{Expected loss in next ten cases} &= 30\% \text{ of ₹ } 1,20,000 + 10\% \text{ of ₹ } 2,00,000 \\ &= ₹ 36,000 + ₹ 20,000 = ₹ 56,000\end{aligned}$$

$$\begin{aligned}\text{Expected loss in remaining five cases} &= 30\% \text{ of ₹ } 1,00,000 + 20\% \text{ of ₹ } 2,10,000 \\ &= ₹ 30,000 + ₹ 42,000 = ₹ 72,000\end{aligned}$$

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 9,20,000 (₹ 56,000 × 10 + ₹ 72,000 × 5) as contingent liability.

**Answer 2**

- There is a present obligation because obligating event is the sales of the pumps with a warranty, which gives rise to an obligation.
- Outflow of resources is probable for the warranties as a whole.
- Best estimation can be made as under  $[6,000 \times (5\% \text{ of } 1,00,000) + 1,000 \times (10\% \text{ of } 1,00,000)] = ₹ 400 \text{ Lakhs}$

- The Company should make a provision for warranty obligation on sale of Vacuum pumps to the extent of ₹ 400 Lakhs.

The Auditor should insist on such provision being created.

If provision is not made, he should qualify his Audit Report.

### Answer 3

#### 1. Computation of Provision at Year – end

Invoice Date	Last date of warranty	Provision as on 31.03.2012	Provision as on 31.03.2013
19.01.2011	19.01.2013	40,000 × 2% = 800	(warranty period has expired) Nil
29.01.2012	29.01.2014	25,000 × 3% = 750	25,000 × 2% = 500
15.10.2012	15.10.2014	Nil (invoice not Yet raised)	90,000 × 3% = 2,700
	<b>Total</b>	<b>1,550</b>	<b>3,200</b>

#### 2. Amount to be provision to profit & Loss A/c for the year ended 31.03.2013

Balance of provision as on 31.03.2013	₹ 3,200
Less: Balance of provision as on 31.03.2012	₹ 1,550
	<u>₹ 1,650</u>

### Answer 4

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 provisions.

Accordingly, potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. In this case, the provision of salary to employees of ₹ 680 lakhs will be ultimately collected from the client, as per the terms of the contract. Therefore, the liability of ₹ 680 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be matched with the reimbursable asset to be claimed from the client. It appears that the whole amount of Rs. 680 lakhs is recoverable

from client and there is no significant uncertainty about the collection. Hence, the net charge to profit and loss account should be nil.

The opinion of the accountant regarding recognition of income of ₹ 680 lakhs is not as per AS- 29 and also the concept of prudence will not be followed if ₹ 680 lakhs is simultaneously recognized as income. ₹ 680 lakhs is not the revenue at present but only reimbursement of claim for which an asset is created. However the accountant is correct to the extent as that non- recognition of ₹ 680 lakhs as income will result in the understatement of profit. To avoid this, in the statement of profit and loss, expense relating to provision may be presented net of the amount recognized for reimbursement.