CA INTERMEDIATE

ADVANCED ACCOUNTING (VOLUME - 2)

CA Nitin Goel

EDITION: Sixth

Published By: Physicswallah Limited

Physics Wallah Publication

ISBN: 978-93-7467-415-4

MRP: 499/-

Mobile App: Physics Wallah (Available on Play Store)

Website: www.pw.live

Youtube Channels: CA Intermediate by PW (@CAintermediatebyPW)

CA Wallah by PW (@CAWallahbyPW)

Commerce Wallah by PW (@CommerceWallahPW)

CA Final by PW (@CAFinalbyPW)

Email: publication@pw.live

SKU Code: 564df45f-7f2f-4596-aad8-02ce04332a58

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PREFACE

A highly skilled professional team of CA Wallah works arduously to ensure that the students receive the best content for their CA-Intermediate exams.

A plethora of CA Study Material is available in the market but CA Wallah professionals at PW are continuously working to provide supreme quality study material for the CA-Intermediate students.

From the beginning, the content team comprising Subject Matter Experts, Content Creators, Reviewers, DTP operators, Proofreaders, and others is involved in shaping the material to their best knowledge and experience to produce powerful content for the students.

CA Wallah Faculties have adopted a novel style of presenting the content in easy-to-understand language and have provided the content team with expert guidance and supervision throughout the creation and curation of this book.

PW's CA Wallah strongly believes in conceptual and fun-based learning. CA Wallah provides highly examoriented content to bring quality and clarity to the students.

This book adopts a multi-faceted approach to mastering and understanding the concepts by having a rich diversity of questions asked in the CA-Intermediate examination and equipping the students with the knowledge for this highly competitive exam.

The main objective of this book is to provide an edge to your preparation with short & crisp yet high-quality content.

BOOK FEATURES

This book, especially designed & amended for CA-Intermediate aspirants, contains:

- Syllabus coverage strictly as per ICAI study Material
- All ICAI Study Material Questions
- Latest RTP & MTP Questions
- Detailed Theory with Exam prototype and Concept Applications Questions
- Short Notes and Solve Miscellaneous Examples
- Topic wise, Learning Plus and Advanced Level Questions covered in the Book
- Past Year Exam Questions Covered
- Elaborated Solutions

ABOUT THE AUTHOR

CA Nitin Sir is a highly accomplished individual who has attained significant achievements in the field of chartered accountancy. He has been awarded the prestigious Chartered Accountant designation with All India Ranks (AIR) at all three levels of the CA Exams, including an AIR of 9th in CPT, AIR of 7th in Intermediate, and AIR of 9th in CA Final. In addition, he is a Gold Medalist from Panjab University in Chandigarh, having been the University Topper for all three years of his B.Com degree.

Nitin Sir's academic pursuits also include a Diploma in IFRS from the ACCA Institute of Britain. His practical experience in the field comes from his tenure at ITC Ltd. where he worked for three years, providing him with a practical perspective that he shares with his students.

As an educator, Nitin Sir has made a significant impact on the field of Chartered Accountancy, having taught over 1,00,000 students in the last 10 years. His teaching methodology focuses on building strong conceptual foundations, and he has developed a comprehensive question bank and handwritten summary charts that are popular among CA students. His commitment to his students' success is evident in their consistently high scores, with many of them scoring 90+ marks in his subjects.

One of Nitin Sir's unique contributions to the field of education is his marathon revisionary videos for CA Foundation and CA Inter, which have a cumulative viewership of over 30 lakhs on social media platforms. These videos offer a comprehensive overview of the material, ensuring that students have a thorough understanding of the concepts before sitting for their exams.

Overall, Nitin Sir's achievements and contributions to the field of chartered accountancy are impressive. His academic and practical experience, coupled with his dedication to his students' success, have made him a highly respected and sought-after educator in the field.

PAPER 1: ADVANCED ACCOUNTING (100 MARKS)

Objective

To acquire the ability to apply specific accounting standards and legislations to different transactions and events and in preparation and presentation of financial statements of various business entities.

Contents

1) Process of formulation of Accounting Standards including Indian Accounting Standards (IFRS converged standards) and IFRSs; Convergence vs Adoption; Objective and Concepts of carve outs.
2) Framework for Preparation and Presentation of Financial Statements (as per Accounting Standards).
3) i. Applicability of Accounting Standards to various entities.
   ii. Application of Accounting Standards:
   - AS 1 Disclosure of Accounting Policies
   - AS 2 Valuation of Inventories
   - AS 3 Cash Flow Statements
   - AS 4 Contingencies and Events Occurring After the Balance Sheet Date
   - AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
   - AS 7 Construction Contracts
   - AS 9 Revenue Recognition
   - AS 10 Property, Plant and Equipment
   - AS 11 The Effects of Changes in Foreign Exchange Rates
   - AS 12 Accounting for Government Grants
   - AS 13 Accounting for Investments
   - AS 14 Accounting for Amalgamations (excluding inter-companyholdings)
   - AS 15 Employee Benefits
   - AS 16 Borrowing Costs
   - AS 17 Segment Reporting
   - AS 18 Related Party Disclosures
   - AS 19 Leases
   - AS 20 Earnings Per Share
   - AS 21 Consolidated Financial Statements of single subsidiaries (excluding problems involving acquisition of Interest in Subsidiary at Different Dates, Cross holding, Disposal of Subsidiary and Foreign Subsidiaries)
   - AS 22 Accounting for Taxes on Income
   - AS 23 Accounting for Investment in Associates in Consolidated Financial Statements
   - AS 24 Discontinuing Operations
   - AS 25 Interim Financial Reporting
   - AS 26 Intangible Assets
   - AS 27 Financial Reporting of Interests in Joint Ventures
   - AS 28 Impairment of Assets
   - AS 29 Provisions, Contingent Liabilities and Contingent Asset
4) Company Accounts
   a. Schedule III to the Companies Act, 2013 (Division I)
   b. Preparation of financial statements – Statement of Profit and Loss, Balance Sheet and Cash Flow Statement
   c. Buy back of securities
   d. Accounting for reconstruction of companies
5) Accounting for Branches including foreign branches

ADVANCED ACCOUNTING: ICAI MODULE BIFURCATION & WEIGHTAGE			
Chapter No.	**Weightage**	**Chapter Name**	
1	55% - 65%	**Introduction to Accounting Standards**	
2		**Framework for Preparation & Presentation of Financial Statements**	
3		**Applicability of Accounting Standards**	
4		**Presentation and Disclosure Based Accounting Standards**	
		Unit 1	AS 1 Disclosure of Accounting Policies
		Unit 2	AS 3 Cash Flow Statement
		Unit 3	AS 17 Segment Reporting
		Unit 4	AS 18 Related Party Disclosures
		Unit 5	AS 20 Earnings per Share
		Unit 6	AS 24 Discontinuing Operations
		Unit 7	AS 25 Interim Financial Reporting
5		**Assets Based Accounting Standards**	
		Unit 1	AS 2 Valuation of Inventory
		Unit 2	AS 10 Property, Plant & Equipment
		Unit 3	AS 13 Accounting for Investments
		Unit 4	AS 16 Borrowing Costs
		Unit 5	AS 19 Leases
		Unit 6	AS 26 Intangible Assets
		Unit 7	AS 28 Impairment of Assets
6		**Liabilities Based Accounting Standards**	
		Unit 1	AS 15 Employee Benefits
		Unit 2	AS 29 Provisions, Contingent Liabilities and Contingent Assets
7		**Accounting Standards Based on Items Impacting Financial Statement**	
		Unit 1	AS 4 Contingencies & Events Occurring After Balance Sheet Date
		Unit 2	AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
		Unit 3	AS 11 The Effects of Changes in Foreign Exchange Rates
		Unit 4	AS 22 Accounting for Taxes on Income
8		**Revenue Based Accounting Standards**	
		Unit 1	AS 7 Construction Contracts
		Unit 2	AS 9 Revenue Recognition
9		**Other Accounting Standards**	
		Unit 1	AS 12 Accounting for Government Grants
		Unit 2	AS 14 Accounting for Amalgamations
10		**Accounting Standards for Consolidated Financial Statements**	
		Unit 1	AS 21 Consolidated Financial Statements
		Unit 2	AS 23 Accounting for Investment in Associates in CFS
		Unit 3	AS 27 Financial Reporting of Interests in Joint Ventures
11	30% - 35%	**Financial Statement of Companies**	
		Unit 1	Financial Statements of Companies
		Unit 2	Cash Flow Statements
12		**Buyback of Securities**	
13		**Amalgamation of Companies**	
14		**Internal Reconstruction**	
15	5% - 10%	**Accounting for Branches including Foreign Branches**	

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WEIGHTAGE IN PAST YEAR EXAMS (From May 18 to Nov 23)

	MAY 18	NOV 18	MAY 19	NOV 19	NOV 20	JAN 21	JULY 21	DEC 21	MAY 22	NOV 22	MAY 23	NOV 23
Financial Statement of Companies	-	-	-	10	-	-	20	-	-	20	10	20
Cash Flow Statement (AS 3)	5	-	10	5	10	12	5	5	5	5	10	-
Buy Back of Securities	10	-	10	15	-	5	15	10	10	5	10+5	5
Internal Reconstruction	-	10	-	15	-	-	5	-	-	20	5	20
Amalgamation (Incl. AS 14)	20	5	10+5	-	15	20+5	10	15+5	20	5	20	5
Branch Accounting	10	-	8	-	10	5	10	10	10	10	5	10
AS 13: A/cing for Investments	10	10	5+1	10	10+5	10+5	20	10+5	5	10+5	10	10
AS 21: Consolidation	20	10	10	10+5	15	20	15+5	15	15	15	15+15	15
Framework	5	5	5	-	5+5	5	5	5+5	-	5	5	-
Basics	-	5	-	-	-	5	-	-	-	5	-	5
AS-1	-	5	-	-	-	-	-	5	5	-	5	5
AS-2	-	-	5+1	5	-	5	5	-	5	5	-	5
AS-4	-	5	5+1	-	-	-	5	5	-	5	-	-
AS-5	5	-	1	-	-	5	-	-	5	5	-	5
AS-7	5	-	5	-	5	-	5	-	5	-	5	-
AS-9	-	-	5	5	-	-	-	5	-	5	5	-
AS-10	-	5	-	-	5	-	5	-	5	-	5	-
AS-11	5	5+5	-	5	-	5	-	5	-	5	5	5
AS-12	5	-	1	-	5	5	5	-	5	-	5	5
AS-16	-	-	5	-	5	-	-	-	5	-	5	5
AS-17	5	-	-	5	5	5	-	-	5	-	5	5
AS-18	-	5	5	-	-	-	5	-	-	-	5	-
AS-19	5	-	5	5	-	5	-	5	5	-	-	-
AS-20	5	5	-	5	-	-	-	5	5	5	-	5
AS-22	5	-	5	5	5	5	5	-	-	5	-	5
AS-24	-	5	-	-	-	-	5	-	-	-	-	5
AS-26	5	-	-	5	5+5	5	-	5	-	-	-	5
AS-29	-	-	-	5	5	-	5	-	5	5	-	-

WEIGHTAGE IN PAST YEAR EXAMS (From May 2024 & onwards)

(Descriptive Portion: 70 Marks)

	MAY 24	SEP 24	JAN 25
Financial Statement of Companies	4	14	-
Cash Flow Statement (AS 3)	7	7	7
Buy Back of Securities	-	7	4
Internal Reconstruction	14	4	14
Amalgamation (Incl. AS 14)	14	14	14
Branch Accounting	6	6	6
AS 13: Accounting for Investments	-	4	-
AS 21: Consolidation	14	14 (With AS 23)	14
Framework	-	-	4
AS-2	7	4	-
AS-7	7	-	-
AS-15	-	5	4
AS-16	7	-	-
AS-18	-	-	4
AS-19	4	-	5
AS-20	4	-	5
AS-22	-	5	-
AS-26	-	4	-
AS-29	-	-	7

For Objective Portion (MCQ's & Case Studies) covering 30 Marks:

Refer MCQ & Case Study Book

INTRODUCTION TO ACCOUNTING STANDARDS

CH 10A

Generally Accepted Accounting Principles (GAAP)	• GAAP refer to a common set of accepted accounting principles, standards, and procedures that business reporting entity must follow when it prepares and present its financial statements. • It's a combination of authoritative standards (set by policy boards) & the commonly accepted ways of recording & reporting accounting information • At international level such authoritative standards are known as **International Financial Reporting Standards (IFRS)** and in India we have authoritative standards named as **AS and IND-AS**
Meaning of AS	Accounting standards are **written policy documents** issued **by expert accounting body** or **by government** with the support of other regulatory bodies [*e.g. MCA issuing AS for companies in consultation with NFRA (National Financial Reporting Authority)*] covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements.
Issues dealt by AS	➢ **Recognition** of events and transactions in the financial statements. ➢ **Measurement** of these transactions and events. ➢ **Presentation** of these transactions & events in financial statements in a manner that is meaningful and understandable to the reader. ➢ The **disclosure** requirements which should be there to enable public at large, the stakeholders and potential investors in particular, to get an insight in to what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.
Objectives	➢ The primary objective is to establish standards which have to be complied with to ensure that the financial statements are prepared in accordance with generally accepted accounting principles. ➢ To provide standard for the diverse accounting policies and principles. ➢ To eliminate the non-comparability of financial statements. ➢ To increase/improve the reliability of the financial statements. ➢ To provide standards which are transparent for users.
Benefits	➢ **Standardization of alternative accounting treatment** (Reduce/ eliminate confusing variations in the accounting treatments used to prepare the financial statements) ➢ **Requirement for additional disclosures.** (disclosures which are not statutorily required) ➢ **Comparability** of financial statements.
Limitations	➢ Difficulties in making choice between different treatments. ➢ Lack of flexibilities ➢ Restricted scope (accounting standards cannot override the statute)

Standards setting process	ICAI has constituted the **Accounting Standard Board** (ASB) in 1977. ASB is responsible for setting accounting standards. Although ASB is a body constituted by council of ICAI, it is independent in the formulation of accounting standards and council of ICAI is not empowered to make any modifications in the draft AS formulated by ASB without consulting with the ASB.
Process	➢ Identification of area (where standardization is required) ➢ Constitution of study groups (for research) ➢ Preparation of draft and its circulation ➢ Ascertainment of views of different bodies on draft (like SEBI, CBDT, C&AG) ➢ Finalization of exposure draft ➢ Comments reviewed on exposure draft (public comments) ➢ Modification of the draft ➢ Issue of AS • For Non Corporate Entities by ICAI • For Corporate Entities by Ministry of Corporate Affairs in consultation with NFRA

NEED FOR CONVERGENCE TOWARDS GLOBAL STANDARDS

Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin.
International analysts and investors would like to compare financial statements based on similar accounting standards, and this has led to the growing support for an internationally accepted set of accounting standards for cross-border filings.

Few aspects which required the need for convergence are : Raising funds from international markets, Comparability of financial statements, Uniformity, Comparability, Transparency etc. and Global Investment.

SIGNIFICANCE:

➢ Global Standards facilitate cross border flow of money, global listing in different stock markets and comparability of financial statements.
➢ The convergence of financial reporting and Accounting Standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders.
➢ It improves the ability of investors to compare investments on a global basis and, thus, lower their risk of errors of judgment.
➢ It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements.

INTERNATIONAL FINANCIAL REPORTING STANDARDS AS GLOBAL STANDARDS

The term **International Financial Reporting Standards (IFRS)** comprises IFRS issued by IASB; IAS issued by International Accounting Standards Committee (IASC); Interpretations issued by the Standard Interpretations Committee (SIC) and Interpretations issued by the IFRS Interpretations Committee of the IASB.
International Financial Reporting Standards (IFRSs) are considered a "principles based" set of standards. In fact, they establish broad rules rather than dictating specific treatments.

BECOMING IFRS COMPLIANT

Any country can become IFRS compliant ***either*** by adoption process or by convergence process.
Adoption would mean that the country sets a specific timetable when specific entities would be required to use IFRS as issued by the IASB.
Convergence means that the country will develop high quality, compatible accounting standards over time. Convergence means alignment of the standards of different standard setters with a certain rate of compromise, by adopting the requirements of the standards either fully or partially. Indian Accounting Standards are almost similar to IFRS but with few carve outs so as to make them suitable for Indian Environment.

Convergence with IFRS will result in following benefits:

- Improves investor confidence across the world with transparency and comparability
- Improves inter-unit/ inter-firm/inter-industry comparison
- Group consolidation will be easy with same standard by all companies in group irrespective of their global location.
- Acceptability of financial statements by stock exchanges across the globe, which will facilitate listing of Indian companies to international stock exchanges.

ISSUE OF IND AS

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders.

Accordingly, while formulating IFRS converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential.

Indian Accounting Standards (Ind AS) are IFRS converged standards issued by the Central Government of India under the supervision and control of Accounting Standards Board (ASB) of ICAI and in consultation with NFRA. NFRA recommends these standards to the MCA and MCA has to spell out the AS applicable for companies in India.
Ind AS are named and numbered in the same way as the corresponding International Financial Reporting Standards (IFRS).

In **July 2014,** the Finance Minister of India at that time, Shri Arun Jaitely ji, in his Budget Speech, announced an urgency to converge the existing accounting standards with the International Financial Reporting Standards (IFRS) through adoption of the new Indian Accounting Standards (Ind AS) by the Indian companies

The Ministry of Corporate Affairs (MCA) has issued the Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 covering the revised roadmap of implementation of Ind AS for companies other than Banking companies, Insurance Companies and NBFCs and Indian Accounting Standards (Ind AS).
As per the Notification, Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) shall be implemented on voluntary basis from 1st April, 2015 and mandatorily from 1st April, 2016. Separate roadmaps have been prescribed for implementation of Ind AS to Banking, Insurance companies and NBFCs respectively.

CARVE OUTS/INS IN IND AS *(RTP May 2024)*

- Various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' and 'balance sheet' in place of 'statement of financial position'.
- Removal of options in accounting principles and practices in Ind AS vis-a-vis IFRS, have been made to maintain consistency and comparability of the financial statements to be prepared by following Ind AS. However, these changes will not result into carve outs.
- Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in economic conditions prevailing in India. These differences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as **'Carve-outs'**.
- Additional guidance given in Ind AS over and above what is given in IFRS, is termed as **'Carve in'**

ROADMAP FOR IMPLEMENTATION OF INDAS:

For Companies other than Banks, NBFCs and Insurance Companies

Phase I: 1st April 2015 or thereafter (with Comparatives): Voluntary Basis for any company (other than Banks, NBFCs and Insurance companies) and its holding, subsidiary, Joint venture (JV) or Associate Company.

1st April 2016: Mandatory Basis

(a) Companies listed/in process of listing on Stock Exchanges in India or Outside India having net worth of INR 500 crore or more;
(b) Unlisted Companies having net worth of INR 500 crore or more;
(c) Parent, Subsidiary, Associate and JV of above.

Phase II: 1st April 2017: Mandatory Basis

(a) All companies which are listed/or in process of listing on Stock Exchanges in India or outside India not covered in Phase I (other than companies listed on SME Exchanges);
(b) Unlisted companies having net worth of INR 250 crore or more but less than INR 500 crore;
(c) Parent, Subsidiary, Associate and JV of above.

Special Points to Consider:-

- Companies listed on SME exchange are not required to apply Ind AS. Such companies shall continue to apply existing ASs unless they choose otherwise.
- Once Ind AS are applicable, an entity shall be required to follow the Ind AS for all the subsequent financial statements i.e. there is no looking back once the Ind AS are adopted by companies.
- Companies not covered by the above roadmap shall continue to apply Accounting Standards notified in Companies (Accounting Standards) Rules, 2021.

For Non-Banking Financial Companies (NBFCs), Scheduled Commercial Banks (Excluding RRBs) and Insurers/Insurance Companies

Non-Banking Financial Companies (NBFCs)	
Phase I:	**From 1st April, 2018 (with comparatives)**
	NBFCs (whether listed or unlisted) having net worth INR 500 crores or more
	Holding, Subsidiary, JV & Associate companies of above NBFC other than those already covered under corporate roadmap shall also apply from said date
Phase II:	**From 1st April, 2019 (with comparatives)**
	NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than INR 500 crores
	NBFCs that are unlisted having net worth INR 250 crores or more but less than INR 500 crores
	Holding, Subsidiary, JV and Associate companies of above companies other than those already covered under corporate roadmap shall also apply Ind AS from the said date.
• Applicable to both Consolidated and Individual Financial Statements	
• NBFC having net worth below INR 250 crores and not covered under the above provisions shall continue to apply ASs specified in Annexure to Companies (Accounting Standards) Rules, 2006.	
• Adoption of Ind AS is allowed only when required as per the roadmap	
• Voluntary adoption of Ind AS is not allowed.	
Scheduled Commercial banks (excluding RRBs)	
➢ Scheduled Commercial Banks (SCBs) excluding Regional Rural Banks (RRBs) were initially required to implement Ind AS from 1 April 2018. However, RBI (Reserve Bank of India) vide a press release dated 5 April 2018, deferred the implementation of Ind AS by one year i.e. to be effective from 1 April 2019 instead of 1 April 2018. ➢ Further, the RBI through a notification dated 22 March 2019, deferred the Ind AS implementation till further notice. Urban Cooperative banks (UCBs) and Regional Rural banks (RRBs) are not required to apply Ind AS.	
Insurers/Insurance companies	
➢ MCA had outlined the road map for implementation of Ind AS by insurers/insurance companies from 1 April 2018. ➢ IRDAI (Insurance Regulatory and Development Authority of India) deferred the implementation of Ind AS in the insurance sector in India for a period of two years whereby the effective date was deferred to 1st April 2020. IRDAI, vide circular dated 21 January 2020, has deferred implementation of Ind AS in the insurance sector till further notice.	

APPLICABILITY OF ACCOUNTING STANDARDS

CH 10B

Enterprises to which Accounting Standards apply

Accounting Standards apply in respect of any enterprise (whether organized in corporate, cooperative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes.

AS however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the AS would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature.

Even if a very small proportion of activities of an enterprise were considered to be commercial, industrial or business in nature, the AS would apply to all its activities including those, which are not commercial, industrial or business in nature

LEGAL PROVISION: COMPANIES ACT 2013

- Section 129 (1) of the Companies Act, 2013 requires companies to present their financial statements in accordance with the accounting standards notified under Section 133 of the Companies Act, 2013.
- Also, the auditor is required by Section 143(3)(e) to report whether, in his opinion, the financial statements of the company audited, comply with the accounting standards referred to in Section 133 of the Companies Act, 2013.
- As per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the ICAI in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA)

Criteria for Classification of Non-Company Entities by ICAI

(Applicable for Accounting periods commencing from 01.04.2024)

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

Category	Criterion
MSME	MSME means, a non-company entity- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; (ii) which is not a bank, financial institution or an insurance company; (iii) whose turnover (excluding other income) does not exceed ₹ 250 crore in the immediately preceding accounting year; (iv) which does not have borrowings in excess of ₹ 50 crore at any time during immediately preceding accounting year; and (v) which is not a holding or subsidiary of an entity which is not a micro, small and medium-sized entity. **Explanation**: For the purposes of this clause, a non company entity shall qualify as a MSME, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.
Large Entity	Non-company entities that is not an MSME

Requirements *(Key Disclosures when MSME's avail exemptions or relaxations):*

1. **General Disclosure:**
   An MSME that avails any exemption or relaxation must disclose in its financial statements:
   - That it is an MSME as per the ICAI definition.
   - That it has complied with Accounting Standards applicable to MSMEs.

2. **Partial Exemption Disclosure:**
   If an MSME opts not to avail exemptions in respect of certain Standards but avails them for others, it must specify:
   - The Standards for which it has availed exemption/relaxation.
   - The Standards for which full compliance has been made.

3. **Loss of MSME Status:**
   If an MSME no longer qualifies in the current accounting period, it must:
   - Apply full AS requirements from the current year.
   - Disclose that it had availed exemptions in the prior year.
   - Clarify that previous year figures are not revised solely due to change in classification.

4. **Newly Qualifying MSME:**
   A non-company entity that newly qualifies as an MSME can avail exemptions only after it remains as MSME for 2 consecutive years. Until then, full AS compliance is required.

   These disclosures ensure transparency and help financial statement users understand the basis of preparation and compliance with applicable standards.

AS not applicable to MSME's in their entirety
❖ AS 3 Cash Flow Statements ❖ AS 17 Segment Reporting ❖ AS 20 Earnings per Share ❖ AS 24 Discontinuing Operations *AS 18 Related Party Disclosures & AS 28 Impairment of Assets not applicable in entirety*. • whose Turnover (excluding other income) does not exceed ₹ 50 crore in the immediately preceding accounting year; • which does not have borrowings in excess of ₹ 10 crore at any time during the immediately preceding accounting year; and • which is not a Holding and subsidiary of an MSME not covered above.
Relaxations/exemptions from certain requirements of AS to MSMEs
AS 10 Property, Plant & Equipment AS 11 The Effects of Changes in Foreign Exchange Rates AS 15 Employee Benefits AS 19 Leases AS 22 Accounting for Taxes on Income AS 26 Intangible Assets AS 28 Impairment of Assets AS 29 Provisions, Contingent Liabilities and Contingent Assets

AS 21, 23, 25 & 27 is applicable only if a Non-company entity is required or elects to prepare and present consolidated financial statements or interim financial report.

CRITERIA FOR CLASSIFICATION OF COMPANIES AS PER COMPANIES (ACCOUNTING STANDARDS) RULES, 2021

Company	Criterion
SMC *(Inter Nov 2023) (5 Marks)*	Small and Medium-Sized Company (SMC) as defined in Clause 2(e) of the Companies (Accounting Standards) Rules, 2021: "Small and Medium Sized Company" (SMC) means, a company- (i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; (ii) which is not a bank, financial institution or an insurance company; (iii) whose turnover (excluding other income) does not exceed ₹ 250 crore in the immediately preceding accounting year; (iv) which does not have borrowings (including public deposits) in excess of ₹50 crore at any time during immediately preceding accounting year; and (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company. **Explanation**: For the purposes of clause 2(e), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period
Non-SMCs	Companies not falling within the definition of SMC are considered as Non-SMCs.

Same Additional requirements for Companies as was for non Companies

Note: An existing company, which was previously not an SMC and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of AS available to an SMC until the company remains an SMC for 2 consecutive accounting periods.

AS not applicable to SMC's in their entirety
AS 17 Segment Reporting
AS in respect of which relaxations from certain requirements given to SMCs
AS 15 Employee Benefits AS 19 Leases AS 20 Earnings Per Share *(Disclosure of Diluted EPS is exempted for SMC's)* AS 28 Impairment of Assets AS 29 Provisions, Contingent Liabilities and Contingent Assets

AS 21, 23, 25 & 27 is applicable only if Company is required or elects to prepare and present consolidated financial statements or interim financial report.

LIST OF ACCOUNTING STANDARDS (AS) IN INDIA

AS	AS TITLE	AS	AS TITLE
1	Disclosure of Accounting Policies	16	Borrowing Costs
2	Valuation of Inventories	17	Segment Reporting
3	Cash Flow Statements	18	Related Party Disclosures
4	Events Occurring after Bal. Sheet Date	19	Leases
5	Net P/L for the period, Prior Period Items & Changes in A/cing Policies	20	Earnings Per Share
6	~~Depreciation Accounting~~ -Withdrawn-	21	Consolidated Financial Statements
7	Construction Contracts	22	Accounting for Taxes on Income
8	-Withdrawn-	23	Accounting for Investment in Associates in CFS
9	Revenue Recognition	24	Discontinuing Operations
10	Property, Plant & Equipment	25	Interims Financial Reporting
11	Effects of changes in Foreign Exchange Rates	26	Intangible assets
12	Accounting for Government Grants	27	Financial Reporting of Interest in Joint Ventures
13	Accounting for Investments	28	Impairment of assets
14	Accounting for Amalgamation	29	Provisions, Contingent Liabilities and Contingent Assets
15	Employee Benefits		

Question 1 *(ICAI Study Material)*

Ravi Traders, an unlisted partnership firm, had a turnover of ₹230 crore and borrowings of ₹45 crore during the financial year 2023–24. It is not a bank, financial institution, or insurance company, and also not a subsidiary of any other entity. The firm wishes to avail MSME exemptions for FY 2024–25. Is it eligible?

Solution

Yes, Ravi Traders qualifies as an **MSME** since it meets all five criteria: it is unlisted, not a bank/FI/insurance company, turnover < ₹250 crore, borrowings < ₹50 crore, and not a subsidiary/holding. Hence it can avail MSME exemptions in FY 2024–25.

Further, it has been assumed that Ravi Traders is not newly qualifying as an MSME in FY 2024-25 because a non-company entity that newly qualifies as an MSME can avail exemptions only after it remains as MSME for two consecutive years. Until then, full AS compliance is required.

Question 2 *(ICAI Study Material)*

Om Finserv LLP had a turnover of ₹180 crore and borrowings of ₹55 crore in FY 2023–24. It is not a listed entity or a financial institution or a subsidiary of any entity. Can it classify as an MSME and avail related exemptions in FY 2024–25?

Solution

No, Om Finserv LLP cannot be classified as an MSME because its borrowings exceeded ₹ 50 crore, which violates one of the key conditions for qualifying as an MSME. It will be treated as a Large entity and would have to comply fully with all the applicable Accounting Standards.

Question 3

Comment whether the following Company can be classified as a Small and Medium Sized Company (SMC) as per the Companies (Accounting Standards), Rules, 2021: B Pvt. Ltd., has a turnover of ₹ 45 crores, other income of ₹ 7 crores & bank borrowings of ₹ 9 crores.

Solution

As per the definition of SMC, a company will be a SMC if its turnover does not exceed ₹ 250 crores or borrowings do not exceed ₹ 50 crore. For calculating this turnover, other income is not to be included. Since B Pvt. Ltd., has a turnover of ₹ 45 crores and borrowing of ₹ 9 crores, it will satisfy the definition and can be classified as SMC.

Question 4

A company was classified as Non-SMC in 2021-22. In 2022-23 it has been classified as SMC. The management desires to avail the exemption or relaxations available for SMCs in 2022-23. However, the accountant of the company does not agree with the same. Comment.

Solution

As per Companies (Accounting Standards) Rules, 2021, an existing company, which was previously not an SMC and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of AS available to an SMC until the company remains an SMC for two consecutive accounting periods. Therefore, the management of the company cannot avail the exemptions available with the SMCs for the FY 2022-23.

Question 5

XYZ Ltd., with a turnover of ₹ 50 crores during the previous year and borrowings of ₹ 1 crore during any time in the previous year, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3.2021. Advise the management on the exemptions that are available as per the Companies (AS) Rules, 2021.

Solution

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

Since, XYZ Ltd.'s turnover of ₹ 50 crores does not exceed ₹ 250 crores & borrowings of ₹ 1 crore is less than ₹ 50 crores, it is a small and medium sized company (SMC). In this case, AS 17 will not be applicable to XYZ Ltd.

Relaxations from certain requirements in respect of AS 15, AS 19, AS 20, AS 28 and AS 29 are also available to XYZ Ltd.

AS 21, 23, 25 & 27 is applicable only if Company is required or elects to prepare and present consolidated financial statements or interim financial report.

Question 6 *(RTP May 2022)*

A company with a turnover of ₹ 225 crores and borrowings of ₹ 51 crore during the year ended 31st March, 2021, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3.2021. Advise the management on the exemptions that are available as per Companies (Accounting Standards) Rules, 2021.

Solution:

The companies can be classified under two categories viz SMCs and Non-SMCs under the Companies (Accounting Standards) Rules, 2021. As per the Companies (Accounting Standards) Rules, 2021, criteria for above classification as SMCs, are:

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

- whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
- which is not a bank, financial institution or an insurance company;
- whose turnover (excluding other income) does not exceed rupees two-fifty crores in the immediately preceding accounting year;
- which does not have borrowings (including public deposits) in excess of rupees fifty crores at any time during the immediately preceding accounting year; and
- which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Since, XYZ Ltd.'s turnover was ₹ 225 crores which does not exceed ₹ 250 crores but borrowings of ₹ 51 crore are more than ₹ 50 crores, it is not a small and medium sized company (SMC). The exemptions available to SMC are not available to this company.

Question 7 *(RTP May 2022)*

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

Solution

Accounting Standards apply in respect of any enterprise (whether organized in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes.

Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people).

Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.

DISCLOSURE OF ACCOUNTING POLICIES

AS 1

Objectives		
• *Disclosure of significant accounting policies followed in preparing and presenting financial statements.* • *Manner in which accounting policies are disclosed in financial statements*		
Accounting Policies		
Meaning	**These are:** → Specific accounting principles (Eg: AS 2 – Lower of Cost or NRV) and → Methods of applying those principles (Eg: AS 2 FIFO or Weighted Average) adopted by the enterprise in the preparation & presentation of financial statements.	
Notes	• There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which the enterprises operate make alternative accounting policies acceptable. • Choice of the appropriate accounting policies in these specific circumstances of each enterprise requires considerable judgement by the management of the enterprise.	
Fundamental Accounting Assumptions		
Name	**Going concern**	It is assumed that an enterprise will continue its operations in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations.
	Consistency	It is assumed that accounting policies are consistent from one period to another.
	Accrual	Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid.
Notes	• If the above said assumptions are followed in financial statements, specific disclosure is not required. • If a fundamental accounting assumption is not followed, the fact should be disclosed. • Disclosure is necessary if not followed.	
Considerations in the selection of Accounting Policies		
Primary consideration	Financial statements should present true and fair view of → The state of affairs of the enterprise as at the balance sheet date and → The profit or loss for the period ended on that date	
Secondary consideration	**Prudence**	While recognizing the incomes, expenses and losses the principle of prudence should be followed. The income should be recognized only when it is certain to be received. (Profits are not anticipated) The provision should be created for all the known liabilities and losses.

	Substance over form	It implies that suitable changes may be made in the legal form of presentation to disclose the substance in a true and fair manner. ***Example:*** a) Agreement to Sell b) Hire Purchase Transaction
	Materiality	Any item of financial statements which can influence the decision of user is termed as material item & all material items should be disclosed in the financial statements. **Example**: A company should disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or 1,00,000 whichever is higher. (Sch III)
Disclosure of Accounting Policies		
Points to note	➢ All the accounting policies need to be disclosed at one place ➢ These should form an integral part of the financial statements. ➢ These are usually disclosed in "Notes to Accounts"	
Examples (Areas in which different accounting policies may be adopted)	• Valuation of Inventory • Treatment of Goodwill • Valuation of Investment • Treatment of Retirement benefit • Valuation of Property, Plant & Equipment (PPE) • Treatment of Contingent liabilities. • Treatment of Expenditure during construction • Conversion or translation of Foreign currency items.	
Change in an Accounting Policy		
When change can be done?	Accounting policy may be changed only if → Required by Statute → For Compliance with an Accounting Standard → For better presentation or true and fair view of the financial statements	
Points to note	• Any change in an accounting policy 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 • The amount by which any item 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. • Any change in policy which does not affect the current period but can have material effect in the later periods, then such fact should be disclosed.	
Disclosure requirement	• Old policy • New policy • Reason for change in policy • Impact of such change	

ASSIGNMENT QUESTIONS

Question 1

X Limited has sold its building for ₹ 50 lakhs to the purchaser who has paid the full price. Company has given possession to the purchaser. The book value of the building is ₹ 35 lakhs. As at 31st March, 2022, documentation and legal formalities are pending. The company has not recorded the sale. It has shown the amount received as advance. Do you agree with this accounting treatment done by X Ltd.? What accounting treatment should the buyer give in its financial statements?

Solution

Although legal title has not been transferred, the economic reality & substance is that rights and beneficial interest in the immovable property have been transferred. Therefore, recording of disposal by the transferor would in substance represent the transaction entered into.

In view of this, X Ltd. should record the sales and recognize the profit of ₹ 15 lakhs in its Statement of Profit and Loss. It should remove building account from its balance sheet.

Further, in its 'Notes to Accounts', X Ltd. should disclose the following:

"Building has been sold and full consideration has been received and possession of the same has been handed over to the buyer. However, documentation and legal formalities are pending as on 31.3.2022."

The buyer should recognize the building as an asset in his balance sheet and charge depreciation on it. The buyer should disclose in his notes to account that possession has been received however documentation and legal formalities are pending.

Question 2 *(RTP May 2020) (Similar)*

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 & 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 facts need not to be indicated.

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

Solution

(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 fundamental accounting assumptions; 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 significant accounting policies as such should form part of the financial statements and they should be disclosed in one place.

(iv) **False:** Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

(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.

Question 3 *(ICAI Study Material) / (RTP May 2023) (Similar)*

In the books of M/s Prashant Ltd. closing inventory as on 31.03.2022 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 2021-22. On the basis of weighted average method, closing inventory as on 31.03.2022 amounts to ₹ 1,47,000. Realisable value of the inventory as on 31.03.2022 amounts to ₹ 1,95,000.
Discuss disclosure requirement of change in accounting policy as per AS-1.

Solution

As per AS 1 "Disclosure of Accounting Policies", any change in an accounting policy which has a material effect should be disclosed in the financial statements. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

Thus Prashant Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose 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. 2021-22, 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'.

Question 4 *(RTP May 2018) / (RTP May 2021) (Similar) / (ICAI Study Material) (Similar)*

Chp Sep 26

Jagannath Ltd. had made a rights issue of shares in 2021. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2022. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:

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

(ii) Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.

(iii) Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being ₹ 10 crores.

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2021-2022.

Solution

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

Accordingly, the notes on accounts should properly disclose the change and its effect.

Notes on Accounts:

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

Question 5 *(ICAI Study Material)*

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

Solution

AS 1 recognizes 'prudence' as one of the major considerations governing the selection and application of accounting policies. In view of the uncertainty attached to future events, profits are not anticipated but recognized only when realized though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. Also as per AS 1, 'accrual' is one of the fundamental accounting assumptions.

Irrespective of the terms of the contract, so long as the principal amount of a loan is not repaid, the lender cannot be replaced in a disadvantageous position for non-payment of interest in respect of overdue amount. From the aforesaid, it is apparent that the company has an obligation on account of the overdue interest.

In this situation, the company should provide for the liability (since it is not waived by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case. However, in respect of the overdue interest amounts, which are settled, the liability should be accrued to the extent of amounts settled. Non-provision of the overdue interest liability amounts to violation of accrual basis of accounting. Therefore, the treatment, done by the company, of not providing the interest amount from due date to the date of repayment is not correct.

Question 6 *(Inter Nov 2018) (5 M)/(RTP May 2020)/(Nov 2023)/(Jan 2025)(ICAI Study Mat.) (Sim.)*

HIL Ltd. was making provision for non-moving stocks based on no issues having occurred for the last 12 months upto 31.03.2021. The company now wants to make provision based on technical evaluation during the year ending 31.03.2022.

Total value of stock ₹ 120 lakhs

Provision required based on technical evaluation ₹ 3.00 lakhs.

Provision required based on 12 months no issues ₹ 4.00 lakhs.

You are requested to discuss the following points in the light of Accounting Standard (AS)-1:

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

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

Solution

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

In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 4 lakhs to ₹ 3 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of HIL Ltd. for the year 2021-22 in the following manner:

"The company has provided for non-moving inventories on the basis of technical evaluation unlike preceding years. Due to change in method of estimating provision, the profit for the year and the value of net assets at the end of the year would increase by ₹ 1 lakh."

PRACTICE QUESTIONS

Question 1 *(Inter Dec 2021) (5 Marks)*

a) ABC Ltd. was previously making provision for non-moving stocks based on stocks not issued for the last 12 months up to 31.03.2020. Now, the company wants to make provisions based on technical evaluation during the year ending 31.03.2021.
Total value of stock ₹ 133.75 lakhs
Provision required based on technical evaluation ₹ 4.00 lakhs
Provision required based on 12 months not issued ₹ 5.00 lakhs.

b) In the Books of Kay Ltd., Closing stock as on 31st March, 2021 amounts to ₹ 1,24,000 (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 2020-2021. On the basis of weighted average method, closing stock as on 31st March, 2021 amounts to ₹ 1,15,000. Realisable value of the inventory as on 31st March, 2021 amounts to ₹ 1,54,000.

Discuss Disclosure Requirements of change in accounting policy in above cases as per AS 1.

Solution

a) The decision of making provision for non-moving inventories on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving inventories should be made. The method of estimating amount of provision maybe changed in case more prudent estimate canbe made In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 5 lakhs to ₹ 4 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2020 -21:
"The company has provided for non-moving inventories on the basis of technical evaluation unlike preceding years. Due to change in method of estimating provision, the profit for the year and the value of net assets at the end of the year would increase by ₹ 1 lakh."

b) As per AS 1 "Disclosure of Accounting Policies", any change in an accounting policy which has a material effect should be disclosed in the financial statements. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. Thus company 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 inventory at lower of cost & net realizable value. Since net realizable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e. 2020-21, 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 & value of inventory by ₹ 9,000."

Question 2 *(Inter May 2022) (5 Marks) / (ICAI Study Material)*

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

a) 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.

b) If fundamental accounting assumptions are not followed in presentation and preparation

of financial statements, a specific disclosure is not required.

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

d) 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 facts need not to be indicated.

Solution

a) **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.

b) **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 fundamental accounting assumption is not followed, fact should be disclosed.

c) **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 significant accounting policies as such should form part of the financial statements and they should be disclosed in one place.

d) **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.

Question 3 *(ICAI Study Material)*

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

Solution

There are various areas where different accounting policies could be adopted by different entities within the same industry. An entity may choose to value its inventories using FIFO method, whereas another entity may choose to value the same using Weighted Average method. While an entity is free to choose its accounting policy as long as in the financial statements reflect a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended, the application of different accounting policies by different entities affects the comparability of the financial statements of such different entities by stakeholders, analysts, investors etc.

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

Question 4 *(Inter May 2023) (5 Marks)*

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

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

b) Cee Limited sold its Office Building for ₹ 10,00,000 on 1st March, 2023. The buyer has paid

the full amount and taken possession of the building. The book value of the Office Building is ₹ 4,00,000. On 31st March 2023, documentation and legal formalities are pending. The company has not recorded the disposal and the amount received is shown as an advance.

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

d) Jee Limited disclosed significant accounting policies adopted in the preparation of financial statements, in the Directors' Report.

Solution

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

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

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

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

Question 5 *(Inter Nov 2023) (5 Marks)*

Discuss Disclosure requirements in following cases as per AS 1.

(i) Accountant of A Ltd. charges a probable loss of losing a suit in books of accounts and also disclosed the same fact in financial statements. The probability of losing the suit is 25%.

(ii) Accountant of A Ltd. capitalized all the revenue expenses of repair and maintenance during the year to Plant & Machinery and is also disclosing the same as company policy in financial statements.

(iii) A Ltd. has followed accrual basis of accounting since incorporation. The chief accountant also disclosed this fact in financial statements.

(iv) A Ltd. was providing for after sales expenses @ 2% of sales for covering expenses during the warranty period. Now A Ltd. observes that actual after sales expenses were much less as compared to provision because of better technology used in manufacturing of the products. Now, the Board of A Ltd. decides to account for these expenses as and when they occur. Sales during the period are ₹ 50 crores.

Solution

(i) In this case, accountant of company created a provision for damages of probability of losing a suit by a charge against profits. Unless the probability of losing the suit is more than probability of not losing it, there should not be any creation of provision for such probable losses. So there is no need to charge such loss against profit and disclosing the same in financial statements.

(ii) Repairs and maintenance are revenue expenditure and should not be added to the value of assets, as these expenses do not increase the capacity of asset. Hence such expenses should be charged to profit & loss statement. Further the chief accountant also disclosed its policy of adding repairs to value of assets by way of notes to accounts. As per AS 1 disclosure is not a method to correct the wrong treatments. So the contention of chief accountant is wrong.

(iii) Accrual is one of the Fundamental accounting assumptions. If fundamental accounting assumptions are followed properly then no specific disclosure is required. Disclosure is required only when there is deviation and the company is not following fundamental accounting assumptions. So the company need not disclose this in financial statements.

(iv) As per AS 1, any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. Accordingly, the notes on accounts should properly disclose the change and its effect.

Note: So far, the company has been providing 2% of sales for meeting after sales expenses during the warranty period. Now the company has improved the quality of its products with better technology and has been observing that actual expenses are very less than the provision, Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 1 crore than would have been the case if the old policy were to continue.

Question 6 *(ICAI Study Material)*

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

Solution

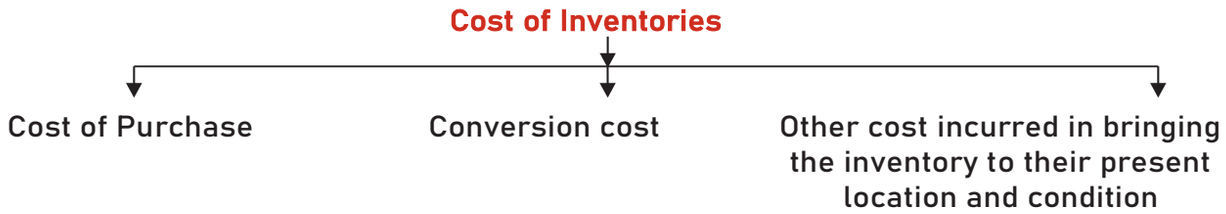
Accounting Standard 1, Disclosure of Accounting Policies, lay down the manner in which accounting policies have to be disclosed, which is stated as under:

- To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
- Such disclosure should form part of the financial statements.
- All the disclosures should be made at one place instead of being scattered over several statements, schedules and notes.

VALUATION OF INVENTORIES

AS 2

Meaning of Inventories	These are the assets: → Held for sale in the ordinary course of business (Finished goods/Stock in trade) → In the process of production for such sale (Work –in-Progress) → In the form of material or supplies to be consumed in the production process or in the rendering of services (raw material, stores and spares*, etc.) * *Inventories do not include spare parts, servicing equipment & standby equipment which meet the definition of property, plant and equipment as per AS 10. Such items are accounted for in accordance with AS 10.*
Common Classification of Inventories	(a) Raw materials & components (b) Work-in progress (c) Finished goods (d) Stock-in- trade (in respect of goods acquired for trading) (e) Stores and spares (f) Loose tools (g) Others (specify nature).
Non – Applicability	This standard does not apply to: • WIP arising under construction contracts • WIP of service providers • Shares, debentures & other financial instruments held as stock in trade • Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.
Measurement (PARA 5)	**Inventories should be valued at Lower of Cost or Net Realizable Value**

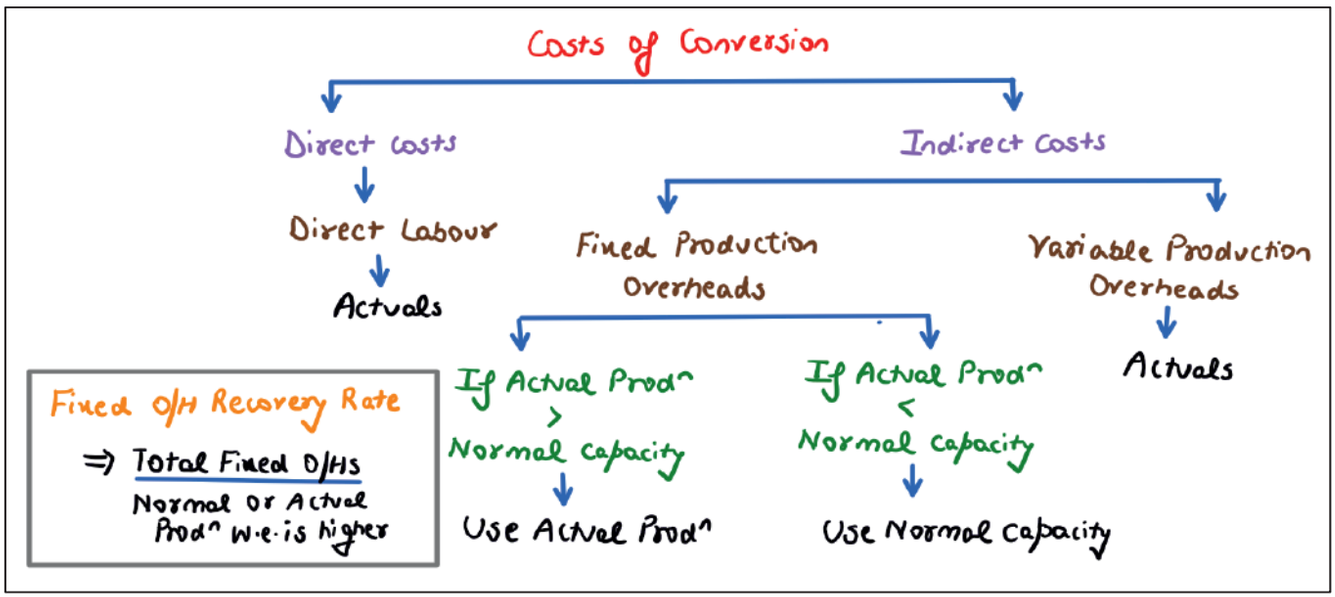


A. COST OF PURCHASE

Purchase Price (Net of Trade discount and rebates)		XX
Add	Duties and Taxes (non-refundable)	XX
Add	Freight inwards	XX
Add	Other expenditure directly attributable to the acquisition (Note)	XX
Cost of Purchase		**XX**

Note: Examples of expenditure directly attributable for purchases are- (a) Costs of Containers (b) Transit Insurance, (c) Buying Commission where purchase of material is possible only through buying agents

B. COST OF CONVERSION



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

Case 1:

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

Case 2:

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

Case 3:

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

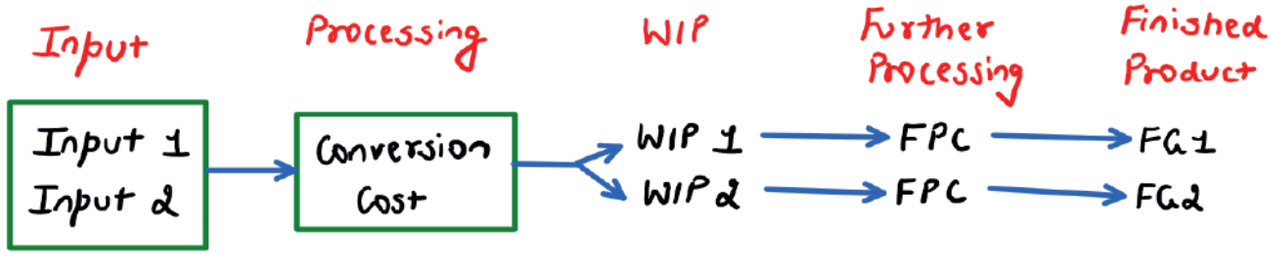
COST OF CONVERSION IN CASE OF PRODUCTION PROCESS RESULTING IN MORE THAN ONE PRODUCT BEING PRODUCED SIMULTANEOUSLY

(NOT SEPARATELY IDENTIFIABLE)

CASE 1: JOINT PRODUCT:

When the cost of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis.

Allocation may be based for e.g., Relative sales value of each product either at the stage in production process when the products become separately identifiable or at the completion of production.



Basis of Allocation of Conversion Cost

At the stage in Production process	At the completion of Production
↓	↓
On the relative sales value of WIP 1 and WIP 2	On the relative sales value of FG 1 and FG 2

CASE 2: MAIN PRODUCT AND BY PRODUCT:

- Most by products as well as scrap or waste materials, by their nature are immaterial.
- In such a case, they are measured at NRV and such value is deducted from the cost of main product.

C. OTHER COST

Other costs are included in cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

Example: Cost of designing products for specific customers.

EXCLUSIONS FROM THE COST OF INVENTORIES

- Abnormal amount of wasted materials, labour or other production cost (Abnormal loss)
- Storage cost unless those are necessary in the production process prior to a further production stage.
- Administrative overheads that do not contribute to bringing the inventories to their present location and condition.
- Selling and distribution cost
- Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are therefore usually not included in cost of inventory *(Exception: AS 16 Borrowing Costs)*

COST FORMULAS

For items that are not ordinarily interchangeable	For other items
Specific identification of cost method: Specific costs are attributed to identified items of inventory	FIFO: Inventory which were purchased or produced first are sold or consumed first. or Weighted Average method: Weighted average of cost of similar items

TECHNIQUES FOR MEASUREMENT OF COST

(May Be Used for Convenience if Results Approximate Actual Cost)

Standard Cost method	Retail method
Takes into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilization	• Often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins. • Inventory = Sales value of inventory – GP %

Example

Calculate cost of inventories using adjusted selling price/retail method:
Sales = 2,00,000 Purchases = 2,00,000 Closing Stock at selling price = 50,000

NET REALISABLE VALUE (NRV)

Estimated Selling Price	XX
Less: Estimated selling expenses	(XX)
Less: Estimated cost of completion	(XX)
NRV	**XX**

- ❖ NRV is to be seen on each and every balance sheet date.
- ❖ Inventories should be usually written down to NRV on an item by item basis (individual basis) and not on global basis.
- ❖ In case of firm/committed contract of sale, NRV shall be calculated at the contract price.

Example

X Ltd deals in 2 products A & B neither similar nor interchangeable. At the end of year, the Historical Cost and NRV of items of closing stock are given below. Determine the value of closing stock.

Items	Historical Cost	Net Realizable Value
Item 1	50,000	45,000
Item 2	20,000	24,000

Example

Closing Stock: 3,000 units. Cost per Unit 40. Selling Price per Unit 45.
There is firm contract for 1,000 units @ 37 per unit.

VALUATION OF MATERIALS AND OTHER SUPPLIES (PARA 24)

If finished product in which such raw material is to be used is expected to be sold at or above cost price [$SP_{FG} \geq CP_{FG}$]	Other cases [$SP_{FG} < CP_{FG}$]
Value Raw Material at Cost Price.	Value Raw Material at Lower of Cost price or Replacement price [CP or RP ↓]

DISCLOSURE REQUIREMENTS

- Accounting policies adopted in measuring inventories
- Cost formula used
- Total carrying amount of inventories
- Classification of amount of inventories

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no.*_____

Cost of a partly finished unit at end of 2021-22 is ₹ 150. The unit can be finished next year by a further expenditure of ₹ 100.The finished unit can be sold at ₹ 250 subject to payment of 4% brokerage on selling price. Assume that partly finished goods cannot be sold in semi finished form and its NRV is zero without processing it further. What is the value of inventory?

Question 2 *Pg no.*_____

A company had 5,000 units of stock "A", costing @ ₹ 50 each on 31.3.2022. Out of this stock, 3,000 units are to be supplied under a firm contract at ₹ 45 each. Show how the valuation will be done of such stock when

(i) the general selling price is ₹ 49 each.
(ii) the general selling price is ₹ 52 each.

Question 3 *Pg no.*_____

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

(a) 400 coats, which had cost ₹ 80 each and normally sold for ₹ 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.

(b) 800 skirts, which had cost ₹ 20 each. These too were found to be defective. Remedial work in April cost ₹ 5 per skirt and selling expenses for the batch totaled ₹ 800. They were sold for ₹ 28 each. What should the inventory value be according to AS 2 after considering the above items?

Question 4 *(ICAI Study Material)* *Pg no.*_____

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

	₹ Per kg
Material cost	200
Direct labour	40
Direct variable overhead	20

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

Question 5 *(Inter May 2022) (5 Marks)* *Pg no.*_____

SM Enterprises is a leading distributor of petrol. A detailed inventory of petrol in hand is taken when the books are closed at the end of each month.

For the month ending June 2021 following information is available:

(i) Sales for the month of June 2021 was ₹30,40,000.
(ii) General overheads cost ₹4,00,000.
(iii) Inventory at beginning 10,000 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:

a) Value of Inventory on 30th June, 2021.
b) Amount of cost of goods sold for June,2021.
c) Profit/Loss for the month of June,2021.

Question 6 *(RTP May 2022)* *Pg no.*_____

Find value of inventory (by periodic inventory method) as per AS 2, to be considered while preparing Balance Sheet as on 31st Mar, 2022 on weighted Average Basis.

Details of Purchases:

Date of Purchase	Unit (Nos)	Purchase cost per unit
01-03-2022	20	108
08-03-2022	15	107
17-03-2022	30	109
25-03-2022	15	107

Details of Issue of Inventory:

Date of Issue	Unit (Nos)
03-03-2022	10
12-03-2022	20
18-03-2022	10
24-03-2022	20

Net realizable value of inventory as on 31st March, 2022 is ₹ 107.75 per unit. What will be the value of Inventory as per AS 2?

Question 7 *Pg no.*_____

ABC Pvt. Limited ordered 10,000 kg. of certain material at ₹ 100 per kg. The purchase price includes GST ₹ 10 per kg., in respect of which full credit is admissible. Freight, Loading and Unloading incurred amounted to ₹ 40,800. Normal Transit Loss is 2%. Enterprise, actually received 9760 kg. & consumed 9500 kg.

Determine cost of inventory and allocation of material cost as per AS–2.

Question 8 *(ICAI Study Material)* *Pg no.*_____

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

Question 9 *Pg no.*_____

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

Direct Labour ₹ 10,00,000

Direct Variable Overheads ₹ 1,00,000

Direct Fixed Overheads ₹ 1,00,000 (Including interest ₹ 40,625)

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

Question 10 *Pg no.*_____

Z Limited ordered 13,000 kg. of chemicals at ₹ 90 per kg. The purchase price includes GST of ₹ 5 per kg, in respect of which full credit is admissible. Freight incurred amounted to ₹ 30,000. Normal transit loss is 4%. The company actually received 12,400 kg and consumed 10,000 kg. The company has received trade discount in the form of cash amounting to ₹ 1 per kg. The chemicals were delivered in containers. The containers were not reusable, hence sold for ₹ 500. The administrative expenses incurred to bring the chemicals were ₹ 10,000.

Compute the value of inventory and allocate the material cost as per AS-2

Question 11

Pg no._____

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

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

Average market price of MP1 and MP2 is ₹ 80 per unit and ₹ 50 per unit respectively, by-product is sold @ ₹ 25 per unit. On By-product separate processing charges of ₹ 4,000 and packing charges of ₹ 6,000 incurred and also ₹ 6,000 was realised from sale of scrap. Calculate the value of closing inventory of MP1 and MP2.

Question 12 *(ICAI Study Material)*

Pg no._____

A trader purchased certain articles for ₹ 85,000. He sold some of articles for ₹ 1,05,000. The average percentage of gross markup is 25% on cost. Opening stock of inventory at cost was ₹ 15,000. Compute Closing Stock.

Question 13

Pg no._____

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 GST	200
GST (Credit is receivable on the GST 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 14 *(ICAI Study Material)*

Pg no._____

Mr. Mehul gives the following information relating to items forming part of inventory as on 31-3-2022. His factory produces Product X using Raw material A.

a) 600 units of Raw material A (purchased @ ₹ 120). Replacement cost of raw material A as on 31-3-2022 is ₹ 90 per unit.
b) 500 units of partly finished goods in process of producing X & cost incurred till date ₹ 260 per unit. These units can be finished next year by incurring additional cost of ₹ 60 per unit.
c) 1500 units of finished Product X and total cost incurred ₹ 320 per unit.

Expected selling price of Product X is ₹ 300 per unit. Determine how each item of inventory will be valued as on 31-3-2022. Also calculate the value of total inventory as on 31-3-2022.

Question 15 *(RTP May 2020)* *Pg no.*_____

Calculate the closing inventory considering the following data:

Particulars		Kg	₹
Opening Inventory	Finished Goods	1,000	25,000
	Raw Materials	1,100	11,000
Purchases		10,000	1,00,000
Labour			76,500
Fixed Overheads			75,000
Sales		10,000	2,80,000
Closing Inventory	Raw Materials	900	
	Finished Goods	1,200	

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

Solution

Calculation of cost of closing inventory

Particulars	₹
Purchase costs (10,200*10)	1,02,000
Direct Labour	76,500
Fixed Overheads (75,000/15,000*10,200)	51,000
Cost of Production	2,29,500
Cost of closing inventory per unit (2,29,500/10,200)	22.50
Net realizable value per unit	20.00

Since net realizable value is less than cost, closing inventory will be valued at ₹ 20.
As NRV of the finished goods is less than its cost, relevant raw materials will be valued at replacement cost ₹ 9.50.
Therefore, value of closing inventory

Finished Goods:	1,200*20	=	24,000
Raw Materials:	900*9.50	=	8,550
			32,550

Question 16 *Pg no.*_____

The company X Ltd, has to pay for delay in cotton clearing charges. The company up to 31.3.2021 has included such charges in the valuation of closing stock. This being in the nature of interest, X Ltd. decided to exclude such charges from closing stock for the year 2021-22. This would result in decrease in profit by ₹ 5 lakhs. Comment.

Solution

As per AS 2, interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are therefore, usually not included in the cost of inventories. However, X Ltd. was in practice to charge the cost for delay in cotton clearing in the closing stock. As X Ltd. decided to change this valuation procedure of closing stock, this treatment will be considered as a change in accounting policy and such fact to be disclosed as per AS 1. Therefore, any change in amount mentioned in financial statement, which will affect the financial position of the company should be disclosed properly as per AS 1, AS 2 and AS 5.
Also a note should be given in the annual accounts that, due to change in system of valuation of closing stock, the profit before tax will decrease by ₹ 5 lakhs.

Question 17 *(RTP Nov 2023) / (ICAI Study Material)* *Pg no.*_____

Alpha Ltd. sells flavored milk to customers; some of the customers consume the milk in the shop run by Alpha Limited. While leaving the shop, the consumers leave the empty bottles in the shop and the company takes possession of these empty bottles. The company has laid down a detailed internal record procedure for accounting for these empty bottles which are sold by the company by calling for tenders. Keeping this in view:

a) Decide whether the inventory of empty bottles is an asset of the company;
b) If so, whether the inventory of empty bottles existing as on the date of Balance Sheet is to be considered as inventories of the company and valued as per AS 2 or to be treated as scrap and shown at realizable value with corresponding credit to 'Other Income'?

Solution

a) Tangible objects or intangible rights carrying probable future benefits, owned by an enterprise are called assets. Alpha Ltd. sells these empty bottles by calling tenders. It means further benefits are accrued on its sale. Therefore, empty bottles are assets for the company.
b) As per AS 2 "Valuation of Inventories", inventories are assets held for sale in the ordinary course of business. Inventory of empty bottles existing on the Balance Sheet date is the inventory and Alpha Ltd. has detailed controlled recording and accounting procedure which duly signify its materiality. Hence inventory of empty bottles cannot be considered as scrap and should be valued as inventory in accordance with AS 2.

Question 18 *(RTP May 2018)* *Pg no.*_____

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

Solution

AS 2 "Valuation of Inventories" states that inventories should be valued at lower of historical cost and net realizable value. The standard states, "at certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases, when sale is assured under forward contract or a government guarantee or when market exists and there is a negligible risk of failure to sell, the goods are often valued at net realisable value at certain stages of production."

Terry Towels do not fall in the category of agricultural crops or mineral ores. Accordingly, taking into account the facts stated, the closing inventory of finished goods (Fancy terry towel) should have been valued at lower of cost and net realisable value and not at net realisable value. Further, export incentives are recorded only in the year the export sale takes place. Therefore, the policy adopted by the company for valuing its closing inventory of inventories of finished goods is not correct.

Question 19 *(RTP May 2022)* *Pg no.*_____

Rohan Pvt. Ltd., wholesaler in agriculture products, has valued inventory on Net Realizable Value on the ground that AS 2 does not apply to inventory of agriculture products.

Solution

AS 2 does not apply to producers of agricultural products but applies to traders in agricultural products. Hence AS 2 will apply to Rohan Pvt. Ltd. and it will have to value inventory at lower of cost or net realizable value.

PRACTICE QUESTIONS

Question 1 *(ICAI Study Material)* Pg no._____

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2021-22, the Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

	Historical Cost (₹ In Lakhs)	Net Realisable Value (₹ In Lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of Closing Stock?

Solution

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

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

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

Question 2 *(Inter May 2019) (1 Mark)* Pg no._____

State whether the following statements is 'True' or 'False'. Also give reason for your answer.
As per provisions of AS-2, inventories should be valued at the lower of cost and selling price.

Solution

False: Inventories should be valued at the lower of cost and net realizable value (not selling price) as per AS 2.

Question 3 *(RTP May 2019) / (RTP Nov 2021) (Similar) / (ICAI Study Material)* Pg no._____

On 31st March 2021 a business firm finds that cost of a partly finished unit on that date is ₹ 530. The unit can be finished in 2021-22 by an additional expenditure of ₹ 310. The finished unit can be sold for ₹ 750 subject to payment of 4% brokerage on selling price.
The firm seeks your advice regarding the amount at which the unfinished unit should be valued as at 31st March, 2021 for preparation of final accounts.
Assume that partly finished goods cannot be sold in semi finished form and its NRV is zero without processing it further.

Solution

Valuation of unfinished unit

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

Question 4 *(RTP Nov 2019) (Similar) / (ICAI Study Material)* *Pg no.*_____

X Co. Limited purchased goods at the cost of ₹ 40 lakhs in October,2021. Till the end of March 2022, 75% of the stocks were sold. The company wants to disclose closing stock at ₹ 10 lakhs. The expected sale value is ₹ 11 lakhs and a commission at 10% on sale is payable to the agent. Advise what is the correct closing stock to be disclosed as at 31.03.2022?

Solution

As per para 5 of AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value.
In this case, the cost of inventory is ₹ 10 lakhs.
The net realizable value is (11,00,000 – 11,00,000 × 10%) = ₹ 9,90,000.
So, the stock should be valued at ₹ 9,90,000.

Question 5 *Pg no.*_____

The closing inventory at cost of XYZ Ltd. amounted to ₹ 9,56,700. 350 Shirts, which had cost ₹ 380 each and normally sold for ₹ 750 each are included in this amount of ₹ 9,56,700. Owing to a defect in manufacture, they were all sold after the Balance Sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds. What should be the closing inventory value?

Solution

Calculation of value of closing inventory

Value of closing inventory (given)	9,56,700
Less: Adjustment to bring the stock of shirts at NRV (W.N 1)	(8,313)
Revised value of closing inventory as per AS 2	9,48,387

Working Notes 1: Valuation of Shirts as per AS 2

Cost price (per shirt)		380
NRV per shirt :		
Sale price (per shirt) ₹ 750 × 50%	= 375.00	
Less: Selling expenses (5% of ₹ 375)	= (18.75)	
NRV (per shirt)	= 356.25	356.25
As per AS 2, inventories are valued at cost or NRV whichever is less		356.25
Difference of cost and NRV		**23.75**
Therefore, value of inventory of shirts to be reduced by ₹ 8,313 (approx) (₹ 23.75 x 350 shirts)		

Question 6 *(RTP Nov 2022) (Similar)* *Pg no.*_____

The closing stock of finished goods at cost of a company amounted to ₹ 4,50,000. The following items were included at cost in the total:

(a) 100 coats, which had cost ₹ 2,200 each and normally sold for ₹ 4,000 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal selling price.

(b) 200 skirts, which had cost ₹ 50 each. These too were found to be defective. Remedial work in April cost ₹ 2 per skirt and selling expenses for the batch totaled ₹ 200. They were sold for ₹ 55 each.

(c) Shirts which had cost ₹ 50,000, their net realizable value at Balance sheet date was ₹ 55,000. Commission @ 10% on sales is payable to agents.

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

Solution

Valuation of closing stock

Closing stock at cost	4,50,000
Less: Adjustment for 100 coats (Working Note 1)	(20,000)
Value of inventory	**4,30,000**

Working Notes:

1. Adjustment for Coats

Cost included in Closing Stock	2,20,000	
NRV of Coats	2,00,000	
Adjustment to be made as NRV is less than Cost		20,000

2. No adjustment required for skirts and shirts as their NRV is more than their cost which was included in value of inventory.
   a. For Skirts Cost = 50*200 = 10,000 NRV = 55-2-1 (200/200) = 52*200 = 10400
   b. For Shirts Cost = 50,000 NRV = 55,000 (word NRV is written so its after Commission)

Question 7 *(RTP May 2021)* *Pg no._____*

The inventory of Rich Ltd. as on 31st March, 2022 comprises of Product – A: 200 units and Product – B: 800 units.

Details of cost for these products are:

Product – A: Material cost, wages cost and overhead cost of each unit are ₹ 40, ₹ 30 and ₹ 20 respectively, Each unit is sold at ₹ 110, selling expenses amounts to 10% of selling costs. **Product – B:** Material cost and wages cost of each unit are ₹ 45 and ₹ 35 respectively and normal selling rate is ₹ 150 each, however due to defect in the manufacturing process 800 units of Product-B were expected to be sold at ₹ 70.

You are requested to value closing inventory according to AS 2 after considering the above.

Solution

According to AS 2 'Valuation of Inventories', inventories should be valued at the lower of cost and net realizable value.

Product – A

Material cost	40 * 200 = 8,000	
Wages cost	30 * 200 = 6,000	
Overhead	20 * 200 = 4,000	
Total cost		18,000
Realizable value [200 x (110-11)]		19,800
Hence inventory value of Product –A		18,000

Product – B

Material cost	45 * 800 = 36,000	
Wages cost	35 * 800 = 28,000	
Total cost		64,000
Realizable value [800 x 70]		56,000
Hence inventory value of Product –B		56,000

Total Value of closing inventory i.e. Product A + Product B (18,000+ 56,000) = 74,000

Question 8 *(RTP May 2023)* *Pg no._____*

An enterprise ordered 20000 kg of certain material at ₹ 110 per unit. The purchase price includes GST at ₹ 12 per kg, in respect of which full input tax credit (ITC) is admissible. Freight incurred amounted to ₹ 1,17,600. Normal transit loss is 2%. The enterprise actually received 19,500 Kg and consumed 18,000 Kg. You are required to calculate cost of material per Kg & Allocation of material cost?

Solution

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

	Kg	₹ /Kg.	₹
Materials consumed	18,000	106	19,08,00
Cost of inventory	1,500	106	1,59,000
Abnormal loss	100	106	10,600
Total material cost	**19,600**		**20,77,600**

Note: Abnormal losses are recognised as separate expense

Question 9 *(ICAI Study Material)* *Pg no._____*

Capital Cables Ltd., has a normal wastage of 4% in the production process. During the year 2021-22 the Company used 12,000 MT of raw material costing ₹ 150 per MT. At the end of the year 630 MT of wastage was in stock. The accountant wants to know how this wastage is to be treated in the books.

Explain in the context of AS 2 the treatment of normal loss and abnormal loss and also find out the amount of abnormal loss if any.

Solution

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

Amount of Abnormal Loss:

Material used 12,000 MT @ ₹150	₹ 18,00,000
Normal Loss (4% of 12,000 MT)	480 MT
Net quantity of material	11,520 MT
Abnormal Loss in quantity	150 MT
Abnormal Loss [150 units @ ₹ 156.25 (₹ 18,00,000/11,520)]	₹ 23,437.50

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

Question 10 *(Inter May 2019) (5 Marks)* *Pg no._____*

Wooden Plywood Limited has a normal wastage of 5% in the production process. During the year 2021-22, the Company used 16,000 MT of Raw material costing ₹ 190 per MT. At the end of the year, 950 MT of wastage was in stock. The accountant wants to know how this wastage is to be treated in the books. You are required to:

(1) Calculate the amount of abnormal loss.

(2) Explain the treatment of normal loss and abnormal loss. [In the context of AS-2 (Revised)]

Solution

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

Amount of Abnormal Loss:
Material used 16,000 MT @ ₹ 190 = ₹ 30,40,000
Normal Loss (5% of 16,000 MT) 800 MT (included in calculation of cost of inventories)
Net quantity of material 15,200 MT

Abnormal Loss in quantity (950 - 800) 150 MT
Abnormal Loss ₹ 30,000 [150 units @ ₹ 200 (₹ 30,40,000/15,200)]
Amount of ₹ 30,000 (Abnormal loss) will be charged to the Profit and Loss statement.

Question 11 *(RTP Nov 2018) / (RTP Nov 2020) (Similar)* *Pg no._____*

A Limited is engaged in manufacturing of Chemical Y for which Raw Material X is required. The company provides you following information for the year ended 31st March, 2022.

	₹ per unit
Raw material X	
Cost price	380
Unloading charges	20
Freight inward	40
Replacement cost	300
Chemical Y	
Material consumed	440
Direct labour	120
Variable overhead	80

Additional Information:
(i) Total fixed overhead for the year was ₹ 4,00,000 on normal capacity of 20,000 units.
(ii) Closing balance of Raw Material X was 1,000 units and Chemical Y was 2,400 units.
You are required to calculate the total value of closing stock of Raw Material X and Chemical Y according to AS 2, when
(a) Net realizable value of Chemical Y is ₹ 800 per unit
(b) Net realizable value of Chemical Y is ₹ 600 per unit

Solution
(a) When Net Realizable Value of the Chemical Y is ₹ 800 per unit
NRV is greater than the cost of Finished Goods Y i.e. ₹ 660 (Refer W.N.)
Hence, Raw Material and Finished Goods are to be valued at cost.
Value of Closing Stock:

	Qty.	Rate	Amount
Raw Material X	1,000	440	4,40,000
Finished Goods Y	2,400	660	15,84,000
Total Value of Closing Stock			**20,24,000**

(b) When Net Realizable Value of the Chemical Y is ₹ 600 per unit
NRV is less than the cost of Finished Goods Y i.e. ₹ 660.
Hence, Raw Material is to be valued at replacement cost and Finished Goods are to be valued at NRV since NRV is less than the cost.
Value of Closing Stock:

	Qty.	Rate	Amount
Raw Material X	1,000	300	3,00,000
Finished Goods Y	2,400	600	14,40,000
Total Value of Closing Stock			**17,40,000**

Working Note:

Statement showing cost calculation of Raw material X and Chemical Y

Raw material X	₹ per unit
Cost price	380
Add: Unloading charges	20
Add: Freight inward	40
Cost	**440**
Chemical Y	**₹ per unit**
Material consumed	440
Direct labour	120
Variable overhead	80
Fixed overheads (4,00,000/20,000)	20
Cost	**660**

Question 12

Pg no._____

U.S.A Ltd. purchased raw material @ ₹ 400 per kg. Company does not sell raw material but uses it in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in stock.

As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realizable value of the raw material for valuation of inventories at the end of the year. However replacement cost of raw material is ₹ 300 per kg. How will you value the inventory of raw material?

Solution

As per Para 24 of AS 2, materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost.

However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the stock of raw material at ₹ 30,00,000 (10,000 kg. @ ₹ 300 per kg.).

Question 13 *(Inter Nov 2019) (5 Marks)*

Pg no._____

Mr. Rakshit gives the following information relating to items forming part of inventory as on 31st March, 2022. His factory produces product X using raw material A.

a) 800 units of raw material A (purchased @ ₹140 per unit). Replacement cost of raw material A as on 31st March, 2022 is ₹190 per unit.

b) 650 units of partly finished goods in the process of producing X and cost incurred till date ₹310 per unit. These units can be finished next year by incurring additional cost of ₹50 per unit.

c) 1,800 units of finished product X and total cost incurred ₹360 per unit.

Expected selling price of product X is ₹350 per unit.

In the context of AS-2, determine how each item of inventory will be valued as on 31st March, 2022. Also, calculate the value of total inventory as on 31st March, 2022.

Solution

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at cost or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. In the given case, selling price of product X is ₹350 and total cost per unit for production is ₹360.

Hence the valuation will be done as under:

a) 800 units of raw material will be valued at cost 140.

b) 650 units of partly finished goods will be valued at 300 per unit i.e. lower of cost (₹310) or Net realizable value ₹300 (Estimated selling price ₹ 350/unit less additional cost of ₹50).

c) 1,800 units of finished product X will be valued at NRV of ₹350 per unit since it is lower than cost ₹360 of product X.

Valuation of Total Inventory as on 31.03.2022:

Particulars	Units	Cost (₹)	NRV/ Replacement cost ₹	Value = units x cost or NRV whichever is less (₹)	₹
Raw material A	800	140	190	1,12,000	(800 x 140)
Partly finished goods	650	310	300	1,95,000	(650 x 300)
Finished goods X	1800	360	350	6,30,000	(1,8
Value of Inventory				**9,37,000**	

Pg no._____

Question 14 *(Inter Jan 2021) (5 Marks)*

Mr. Jatin gives the following information relating to the items forming part of the inventory as on 31.03.2021. His enterprise produces product P using Raw Material X.

(i) 900 units of Raw Material X (purchases @ ₹ 100 per unit). Replacement cost of Raw Material X as on 31.03.2021 is ₹ 80 per unit

(ii) 400 units of partly finished goods in the process of producing P. Cost incurred till date is ₹ 245 per unit. These units can be finished next year by incurring additional cost of ₹ 50 per unit.

(iii) 800 units of Finished goods P and total cost incurred is ₹ 295 per unit.

Expected selling price of product P is ₹ 280 per unit, subject to a payment of 5% brokerage on selling price.

Determine how each item of inventory will be valued as on 31.03.2021. Also calculate the value of total Inventory as on 31.03.2021.

Solution

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at cost or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. In the given case, selling price of product P is ₹ 266 and total cost per unit for production is ₹ 295.

Hence the valuation will be done as under:

(i) 900 units of raw material X will be written down to replacement cost as market value of finished product is less than its cost, hence valued at ₹ 80 per unit.
(ii) 400 units of partly finished goods will be valued at 216 per unit i.e., lower of cost (₹ 245) or Net realizable value ₹ 216 (Estimated selling price ₹ 266 per unit less additional cost of ₹ 50).
(iii) 800 units of finished product P will be valued at NRV of ₹ 266 per unit since it is lower than cost ₹ 295.

Particulars	Units	Cost (₹)	NRV/ Replacement cost ₹	Value = units x cost or NRV whichever is less (₹)
Raw material X	900	100	80	72,000
Partly finished goods	400	245	216	86,400
Finished goods P	800	295	266	2,12,800
Value of Inventory				**3,71,200**

Question 15

*Pg no.*_____

CC Ltd., a Pharmaceutical Company, while valuing its finished stock at the year end wants to include interest on Bank Overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses". State your comments on this treatment.

Solution

As per AS 2 "Valuation of Inventories", cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. However, it makes clear that interest and other borrowing costs are usually not included in the cost of inventories because generally such costs are not related in bringing the inventories to their present location and condition.
Therefore, the proposal of CC Ltd. to include interest on bank overdraft as an element of cost is not acceptable because it does not form part of cost of production

Question 16 *(RTP Sep 2024) (Similar)*

*Pg no.*_____

Hema Ltd. is in the business of manufacturing computers. During the year ended 31st March, 2022 the company manufactured 550 computers, it has the policy of valuing finished stock of goods at a standard cost of ₹ 1.8 lakhs per computer.
The details of the cost are as under:

	(₹ in lakhs)
Raw material consumed	400
Direct Labour	250
Variable production overheads	150
Fixed production overheads (including interest of ₹ 100 lakhs)	290

Compute the value of cost per computer for the purpose of closing stock and also comment on the policy of valuation of inventory adopted by Hema Ltd.

Solution

As per AS 2 'Valuation of Inventories', for inclusion in the cost of inventory, allocation of fixed production overheads is based on the normal capacity of the production facilities.
In this, case finished stock has been valued at a standard cost of ₹ 1.8 lakhs per computer which incidentally synchronizes with the value computed on the basis of absorption costing as under:

	(₹ in lakhs)
Raw material consumed	400
Direct Labour	250
Variable production overheads	150
Fixed production overheads (290 - 100)	190
Total cost	**990**

Number of computers produced = 550 computers (Assumed to be normal production)
Cost per computer ₹ 990 lakhs/550 computers = ₹ 1.80 lakhs
Policy of the company to value closing stock on the basis of standard costing is not as per AS 2. As per AS 2, the techniques of standard cost method may be used for convenience if the result approximates to the actual cost. However, standard cost should be regularly reviewed, if necessary, and be revised in the light of the current conditions. In the instant case, the cost of inventory can be conveniently calculated as per absorption costing. Therefore, there is no reason to adopt standard costing method.

Question 17 *(Inter July 2021) (5 Marks)* *Pg no._____*

Joy Ltd. purchased 20,000 kilograms of Raw Material @ ₹ 20 per kilogram during the year 2020-21. They have furnished you with the following further information for the year ended 31st March, 2021:

Particulars	Units	Amount (₹)
Opening Inventory:		
Finished Goods	2,000	1,00,000
Raw Materials	2,200	44,000
Direct Labour		3,06,000
Fixed Overheads		3,00,000
Sales	20,000	11,20,000
Closing Inventory:		
Finished Goods	2,400	
Raw Materials	1,800	

The plant has a capacity to produce 30,000 Units of finished product per annum. However, the actual production of finished products during the year 2020-21 was 20,400 Units. Due to a fall in the market demand, the price of the finished goods in which the raw material has been utilized is expected to be sold @ ₹ 40 per unit. The replacement cost of the raw material was ₹ 19 per kilogram.
You are required to ascertain value of closing inventory as at 31st March, 2021 as per AS 2.

Solution

Statement Showing the Computation of Value of Closing Inventory

Value of Closing Finished Goods

Particulars	Amount (₹)
Cost of Raw Material consumed (20,400 units X ₹ 20 per kg)	4,08,000
Direct Labour	3,06,000
Fixed Overheads (3,00,000/30,000 x 20,400)	2,04,000
Cost of Production	**9,18,000**
Cost of Closing Inventory of Finished Goods per unit (9,18,000/20,400)	45
Net Realizable Value (NRV) per unit	40

Since net realizable value is less than cost, closing inventory of Finished Goods will be valued at ₹ 40 per unit

Value of Closing Raw Materials

As NRV of finished goods is less than its cost, the relevant raw material will be valued at its replacement cost, which is the best available measure of its NRV i.e. @ ₹ 19 per kg.

Therefore, value of closing inventory would be as under:

Finished Goods 2,400 units @ ₹ 40/- per unit	₹ 96,000
Raw Materials 1,800 kg @ ₹ 19/- per kg	₹ 34,200
Total	**₹ 1,30,200**

Working Note:

Calculation of raw material consumed during the year

Particulars	Unit (Kg)
Opening Inventory	2,200
Purchases	20,000
Less: Closing Inventory	(1,800)
Raw Material Consumed	20,400

Question 18 *(RTP May 2022) / (Inter Sep 2024) (4 Marks)* *Pg no._____*

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

Solution

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

(a) abnormal amount of wasted materials, labour, or other production costs;
(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;
(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
(d) selling and distribution costs

Question 19 *(Inter Nov 2022) (5 Marks)* *Pg no._____*

Following information of Sarah Limited is given:

Sarah Limited uses Raw Material 'A' for production of production of Finished Goods 'B'

Closing balance of Raw Material 'A' in units on 31st March,2022	750
	Price Per Unit in ₹
Cost Price	150
Freight inward	10
Replacement Cost	152
Closing balance of Finished Good 'B' in units on 31st March,2022	1,600
	Price Per Unit in ₹
Material Consumed	225
Direct Labour	75
Direct variable overhead	60

Total Fixed Overheads amounts to ₹ 1,00,000 on normal capacity of 20,000 units.

You are required to calculate the value of Closing Stock of Raw materials and Closing Stock of Finished Goods, as on 31st March, 2022, as per AS 2, when selling price of Finished Goods 'B' is ₹ 360 per unit.

Solution

Raw Material A	₹
Cost Price	150
Add: Freight Inward	10
Cost per unit	160
Replacement cost per unit of raw material	152

As per AS 2 (Revised) "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value. Materials and other supplies held for use in the production of inventories are written down below cost if the selling price of finished product containing the material does not exceed the cost of the finished product.
In the given case, net realizable value of the Product 'B' (Finished Goods) is ₹ 360 per unit which is less than its cost ₹ 365 per unit.
Raw Material is to be valued at replacement cost. Value of the closing stock of raw material on 31/03/2022 would be ₹ 1,14,000 (750 units X ₹152 per unit).

Finished Goods B	₹
Materials consumed	225
Direct Labour	75
Direct Variable overheads	60
Fixed overheads (₹ 1,00,000/20,000 units)	5
Cost per unit	365
Net realizable value per unit	360

As per AS 2 (Revised) "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value. Hence, Finished Goods are to be valued at NRV since NRV is less than the cost.
Value of the closing stock of Finished goods as on 31/03/2022 would be ₹ 5,76,000 (1,600 units X ₹ 360 per unit).

Question 20 *(Inter Nov 2023) (5 Marks)* *Pg no._____*

In the following cases, find the value of closing stock as per AS 2:

(i) Sonu is a retailer dealing in toys. During the year, he purchased items worth for ₹ 1,47,000 and made a total sale ₹ 1,54,000. The average percentage of gross margin is 10% on cost. Opening stock of toys at cost was ₹ 20,000.

(ii) On 21st March, 2023, Mohan purchased 250 chairs at ₹ 300 each. The selling price of the chair is ₹ 400 each. Owing to a manufacturing defect, net realisable value of the whole lot of chair was determined at 70% of their normal selling price. No chairs were sold during the year.

Solution

i. Cost of closing inventory is shown below:

	₹
Sale value of opening stock and purchases (₹ 20,000 + ₹1,47,000) x 1.10	1,83,700
Sales	(1,54,000)
Sale value of unsold stock	29,700
Less: Gross Margin (₹ 29,700 / 1.10) x 0.10	(2,700)
Cost of closing inventory	**27,000**

Alternative:

		₹
Opening Stock		20,000
Purchases		1,47,000
Less: Cost of Goods Sold		
Sales	1,54,000	
Gross Profit @10% on cost (1,54,000*10/110)	(14,000)	(1,40,000)
Cost of closing inventory		**27,000**

ii.

Closing stock at cost (250X ₹ 300) (i)	75,000
Net Realizable value of closing stock (₹ 280* × 250) (ii)	70,000
Value of closing stock [lower of (i) and (ii)]	70,000

*400*70% = 280

Question 21 *(Inter May 2024) (7 Marks)* Pg no._____

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

Purchase of Raw Material for manufacturing process of

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

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

On the basis of the above information, you are required to compute the value of closing inventory of Polyester and Nylon.

Solution

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

Determination of value of closing inventory of Polyester and Nylon

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

Working Notes

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

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

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

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

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

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

CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

AS 4

CONTINGENCY	
Meaning	Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events
Contingent Losses	The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements. The estimation of the amount of a contingent loss to be provided for in the financial statements, may be based on judgement made, by management
Contingent Gains	Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.
EVENTS OCCURRING AFTER THE BALANCE SHEET DATE	
Meaning	These are those significant events, both favorable and unfavorable that occur between the balance sheet date and the date on which the financial statements are approved by the board of directors, in the case of company, and the corresponding approving authority, in case of any other entity.

TYPES OF EVENTS (PARA 8)

Adjusting events	Non-Adjusting events
↓	↓
Those which provide further/additional evidence to assist estimation of amounts relating to conditions that existed at the balance sheet date	Those which are indicative of conditions that arose subsequent to balance sheet date or events which do not relate to conditions existing at balance sheet date
Require adjustments to assets and liabilities as at balance sheet date	No accounting treatment: No adjustment of assets & liabilities **(Refer note)**
Example: an adjustment may be made for loss on trade receivable account which is confirmed by insolvency of customer which occurs after the b/sheet date	**Example:** Ordinary decline in market value of investments between the balance sheet date and date on which financial statements are approved does not require any adjustment.

Note: Non adjusting events may be of such significance that they may require a disclosure in the report of approving authority i.e. report of BOD to enable users of financial statements to make proper evaluations and decisions.

Example: Material changes and commitments affecting the financial position of enterprise.

EXCEPTION TO THE RULE OF "NO ACCOUNTING TREATMENT FOR NON ADJUSTING EVENTS"

Fundamental accounting assumption of GOING CONCERN is not appropriate
Deterioration in operating results and financial position
Unusual changes affecting the existing or sub-stratum of the enterprise after the balance sheet date (eg. Destruction of major production plant by fire after the balance date)
Assets and liabilities should be adjusted i.e. financial statements should be prepared by not following fundamental accounting assumption of GOING CONCERN *In case the going concern assumption is not valid (based on events occurring after the balance sheet date), the financial statements are prepared on a* ***liquidation basis.***

SPECIAL CASE: DIVIDEND

There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature.

For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognized as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends should be disclosed in the notes.

NON APPLICABILITY

The following subjects, which may result in contingencies, are **excluded** from the scope of this Standard in view of special considerations applicable to them:

(a) liabilities of life assurance & general insurance enterprises arising from policies issued;
(b) obligations under retirement benefit plans; and
(c) commitments arising from long-term lease contracts.

DISCLOSURE REQUIREMENTS

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

- The nature of the event;
- An estimate of the financial effect, or a statement that such an estimate cannot be made.

ASSIGNMENT QUESTIONS

Question 1

MEC Limited could not recover an amount of ₹ 8 lakhs from a debtor. The company is aware that the debtor is in great financial difficulty. The accounts of the company for the year ended 31-3-2020 were finalized by making a provision @ 25% of the amount due from that debtor. In May 2020, the debtor became bankrupt and nothing is recoverable from him. Do you advise the company to provide for the entire loss of ₹ 8 lakhs in books of account for the year ended 31-3-2020?

Solution

As per para 8 of AS 4, adjustments to assets and liabilities are required for events occurring after the balance sheet date if such event provides/relates to additional information to the conditions existing at the balance sheet date and is also materially affecting the valuation of assets and liabilities on the balance sheet date.

As per the information given in the question, the company was aware that the debtor was already in a great financial difficulty at the time of closing of accounts. Bankruptcy of the debtor in May 2020 is only an additional information to the condition existing on the balance sheet date. Also the effect of a debtor becoming bankrupt is material as total amount of ₹ 8 lakhs will be a loss to the company. Therefore, the company is advised to provide for the entire amount of ₹ 8 lakhs in the books of account for the year ended 31st March, 2020.

Question 2 *(ICAI Study Material)*

In X Co. Ltd., theft of cash of ₹ 5 lakhs by the cashier in January, 2020 was detected only in May, 2020. The accounts of the company were not yet approved by the Board of Directors of the company.

Decide whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.2020.

Solution

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

If a fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognise the loss amounting ₹ 5,00,000 and adjust the accounts of the company for the year ended 31st March, 2020.

Question 3

State with reasons, how the following events would be dealt with in the financial statements of Pradeep Ltd. for the year ended 31st March, 2020:

(i) An agreement to sell a land for ₹ 30 lakh to another company was entered into on 1st March, 2020. The value of land is shown at ₹ 20 lakh in the Balance Sheet. However, the Sale Deed was registered on15th April, 2020.

(ii) The negotiation with another company for acquisition of its business was started on 2nd February, 2020. Pradeep Ltd. invested ₹ 40 lakh on 12th April, 2020.

Solution

(1) According to 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.

In the given case, sale of immovable property was carried out before the closure of the books of accounts. This is clearly an event occurring after the balance sheet date but agreement to sell was effected on 1st March, 2020 i.e. before the balance sheet date. Registration of the sale deed on 15th April, 2020, simply provides additional information relating to the conditions existing at the balance sheet date. Therefore, adjustment to assets for sale of land is necessary in the financial statements of Pradeep Ltd. for the year ended 31st March, 2020.

(2) AS 4 defines "Events occurring after the balance sheet date" as those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2020. Applying provisions of the standard which clearly state that/disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 40 lakhs in April, 2020 in the acquisition of another company should be disclosed in report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

Question 4 *(RTP Nov 2019) (Similar) / (ICAI Study Material)*

An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.2022. The accounting year of the company ended on 31.3.2022. The accounts were approved on 30.6.2022. The loss from earthquake is estimated at ₹ 30 lakhs.

State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

Solution

AS 4,'Contingencies and events occurring after balance sheet date', states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.2022.

However, according to standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per question, the earthquake has caused major destruction; therefore fundamental accounting assumption of going concern would have to be evaluated.

Case 1: If going concern assumption is not Valid

Since the fire occurred after 31/03/22, the loss on fire is not a result of any condition existing on 31/03/22. But the loss due to fire is an adjusting event the entire accounts need to be prepared on a liquidation basis with adequate disclosures by the company by way of note in its financial statements in the following manner:

"Major fire occurred in the warehouse on 20th May, 2022 which has made impossible for the enterprise to start operations again. Therefore, the financial statements have been prepared on liquidation basis."

Case 2: If going concern assumption is still Valid

The fact of earthquake together with an estimated loss of ₹ 30 lakhs should be disclosed in Report of approving authority for the financial year 2021-2022 to enable users of financial statements to make proper evaluations and decisions.

Question 5

Neel Limited has its corporate office in Mumbai and sells its products to stockists all over India. On 31st March, 2020 the company wants to recognize receipt of cheques bearing date 31st March, 2020 or before, as "Cheques in Hand" by reducing "Trade Receivables". The "Cheques in Hand" is shown in the Balance Sheet as an item of cash and cash equivalents. All cheques are presented to the bank in the month of April 2020 and are also realized in the same month in normal course after deposit in the bank.

State with reasons, whether each of the following is an adjusting event and how this fact is to be disclosed by the company, with reference to the relevant accounting standard

(i) Cheques collected by the marketing personnel of the company from the stockists on or before 31st March, 2020.

(ii) Cheques sent by the stockists through courier on or before 31st March, 2020.

Solution

(1) Cheques collected by the marketing personnel of the company is an adjusting event as the marketing personnels are employees of the company and therefore, are representatives of the company. Handing over of cheques by the stockist to the marketing employees discharges the liability of the stockist. Therefore, cheques collected by the marketing personnel of the company on or before 31st March, 2020 require adjustment from the stockists' accounts i.e. from 'Trade Receivables A/c' even though these cheques (dated on or before 31st March, 2020) are presented in the bank in the month of April, 2020 in the normal course. Hence, collection of cheques by the marketing personnel is an adjusting event as per AS 4 'Contingencies and Events Occurring after the Balance Sheet Date'. Such 'cheques in hand' will be shown in the Balance Sheet as 'Cash and Cash equivalents' with a disclosure in the Notes to accounts about the accounting policy followed by the company for such cheques.

(2) Even if the cheques bear the date 31st March or before and are sent by the stockists through courier on or before 31st March, 2020, it is presumed that the cheques will be received after 31st March. Collection of cheques after 31st March, 2020 does not represent any condition existing on the balance sheet date i.e. 31st March. Thus, the collection of cheques after balance sheet date is not an adjusting event. Cheques that are received after the balance sheet date should be accounted for in the period in which they are received even though the same may be dated 31st March or before as per AS 4. Moreover, the collection of cheques after balance sheet date does not represent any material change affecting financial position of the enterprise, so no disclosure in the Director's Report is necessary.

Question 6 *(ICAI Study Material)*

A company has filed a legal suit against the debtor from whom ₹ 15 lakh is recoverable as on 31.3.2020. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 2020. Can the company provide for full amount of ₹ 15 lakhs as provision for doubtful debts?

Solution

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. In the given case, company should make the provision for doubtful debts, as legal suit has been filed on 31st March, 2020 and the chances of recovery from the suit are not good. Though, the actual result of legal suit will be known in

future yet situation of non-recovery from the debtors exists before finalisation of financial statements. Therefore, provision for doubtful debts should be made for the year ended on 31st March, 2020.

Question 7 *(ICAI Study Material)*

During the year 2019-2020, Raj Ltd. was sued by a competitor for ₹ 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of ₹ 10 lakhs in its financial statements for the year ended 31st March, 2020. On 18th May, 2020, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of ₹ 14 lakhs. The financial statements were prepared by the company's management on 30th April, 2020, and approved by the board on 30th May, 2020.
Should Raj Ltd. adjust its financial statements for the year ended 31st March, 2020?

Solution

As per para 8 of AS 4, adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.
In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 2019-20 for which the provision was also made by it, the decision of the Court on 18th May, 2020, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Question 8 *(ICAI Study Material)*

A Limited Company closed its accounting year on 30.6.20 and the accounts for that period were considered and approved by the board of directors on 20th August, 2020. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2020 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs.
You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.20.

Solution

AS 4 defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'.
The given case is discussed in the light of above mentioned definition and requirements given in AS 4.
In this case the incidence, which was expected to push up cost became evident after the date of approval of the accounts. So it is not an 'event occurring after the balance sheet date'.

Question 9

A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price retrospectively.
Can the company account for additional revenue at the close of the year? Discuss in line with provisions of AS 4.

Solution

According to para 8 of AS 4, the unexpected increase in sale price of petrol by the government after the balance sheet date cannot be regarded as an event occurring after the Balance Sheet date, which requires an adjustment at the Balance Sheet date, since it does not represent a condition present at the balance sheet date. The revenue should be recognized only in the subsequent year with proper disclosures.

Question 10

F Ltd. has finalized their financial statements for the year ending 31st March, 2020 and approved by their approving authority on 30th June, 2020.

(a) A major fire broke out in the night of 31st May, 2020 destroying factory premises. Loss of property estimated to be ₹ 25 lakhs.

(b) Negotiations with another company started in April 2020 for acquisition of two manufacturing units which may involve additional investments of ₹ 50 lakhs.

(c) Foreign exchange loss during the period 1st April, 2020 and 1st June 2020 has resulted that assets being reduced by ₹ 30 lakhs.

You are requested to state how to deal with the above information's in the annual accounts.

Solution

For the information given, the following will be recommended treatment with reference to the provisions of AS 4: Contingencies and Events Occurring After the Balance Sheet Date.

a. The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, the event would appear to be of such significance as to require a disclosure in the report of the approving authority to enable users of the financial statements to make proper evaluation and decision, hence, such disclosure is recommended.

b. AS 4 defines events occurring after the balance sheet date as those significant event- both favorable and unfavorable – that occur between the balance sheet date and the date on which the financial statements are approved by the approving authority. Accordingly, negotiation for acquisitions of two manufacturing units which started on 30th April, 2020 should be disclosed in the Board's Report. No adjustments of assets and liabilities are required, as the negotiation does not affect the determination and the conditions of the amounts stated in the financial statements for the year ended 31st March, 2020.

c. The foreign exchange loss due to changes in exchange rates during the period 1st April 2020 and 1st June 2020, is a non adjusting event since it does not relate to the conditions existing at the balance sheet date. The amount of loss appears material and may be of such significance that requires disclosure in the report of the approving authority

Question 11 *(RTP May 2018 / RTP May 2020) (Similar)*

With reference to AS 4 "Contingencies and events occurring after the balance sheet date", state whether the following events will be treated as contingencies, adjusting events or non-adjusting events occurring after balance sheet in case of a company which follows April to March as its financial year.

(a) A major fire has damaged the assets in a factory on 5th April, 5 days after the year end. However, the assets are fully insured and the books have not been approved by the Directors.

(b) A suit against the company's advertisement was filed by a party on 10th April, 10 days after the year end claiming damages of ₹ 20 lakhs.

(c) It sends a proposal to purchase an immovable property for ₹ 30 lakhs in March. The book value of the property is ₹ 20 lakhs as on year end date. However, the deed was registered as on 15th April.
(d) The terms and conditions for acquisition of business of another company have been decided by March end. But the financial resources were arranged in April and amount invested was ₹ 40 lakhs.
(e) Theft of cash of ₹ 2 lakhs by the cashier on 31st March but was detected the next day after the financial statements have been approved by the Directors.

Solution

According to AS 4 on 'Contingencies and Events Occurring after the Balance Sheet Date', adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. However, adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. "Contingencies" used in the Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

(i) Fire has occurred after the balance sheet date and also the loss is totally insured. Therefore, the event becomes immaterial and the event is **non-adjusting** in nature.
(ii) The contingency is restricted to conditions existing at the balance sheet date. However, in the given case, suit was filed against the company's advertisement by a party on 10th April for amount of ₹ 20 lakhs. Therefore, it does not fit into the definition of a contingency and hence is a **non-adjusting** event.
(iii) In the given case, proposal for deal of immovable property was sent before the closure of the books of accounts. This is a non-adjusting event as only the proposal was sent and no agreement was effected in the month of March i.e. before the balance sheet date.
(iv) As the term and conditions of acquisition of business of another company had been decided by the end of March, acquisition of business is an adjusting event occurring after the balance sheet date. Adjustment to assets and liabilities is required since the event affects the determination and the condition of the amounts stated in the financial statements for the financial year ended on 31st March.
(v) Since the financial statements have been approved before detection of theft by the cashier of ₹ 2,00,000, it becomes a non-adjusting event and no disclosure is required in the report of the Approving Authority.

Question 12 *(RTP May 2019)*

The Board of Directors of M/s. New Graphics Ltd. in its Board Meeting held on 18th April, 2020, considered and approved the Audited Financial results along with Auditors Report for the Financial Year ended 31st March, 2020 and recommended a dividend of ₹ 2 per equity share (on 2 crore fully paid up equity shares of ₹ 10 each) for the year ended 31st March, 2020 and if approved by the members at the forthcoming Annual General Meeting of the company on 18th June, 2020, the same will be paid to all the eligible shareholders
Discuss on the accounting treatment and presentation of the said proposed dividend in the annual accounts of the company for the year ended 31st March, 2020 as per the applicable Accounting Standard and other Statutory Requirements

Solution

As per the amendment in AS 4 "Contingencies and Events Occurring After the Balance Sheet Date" vide Companies (Accounting Standards) Amendments Rules, 2016 dated 30th March,

2016, the events which take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. However, dividends declared after the balance sheet date but before approval of financial statements are not recognized as a liability at the balance sheet date because no statutory obligation exists at that time. Hence such dividends are disclosed in the notes to financial statements.

No, provision for proposed dividends is not required to be made. Such proposed dividends are to be disclosed in the notes to financial statements. Accordingly, the dividend of ₹ 4 crores recommended by New Graphics Ltd. in its Board meeting on 18th April, 2020 shall not be accounted for in the books for the year 2019-20 irrespective of the fact that it pertains to the year 2019-20 and will be paid after approval in the Annual General Meeting of the members / shareholders

Question 13 *(RTP May 2022) (Similar)*

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

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

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

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

(iv) The company has received, during the year 2018-2019, a government grant of ₹ 15 lakhs for purchase of a machine. The company has received a notice for refund of the said grant on 15 June, 2020 due to violation of some of the conditions of grant during the year 2019-2020.

(v) A suit against the company's advertisement was filed by a party on 10th April, 2020 10 days after the year end claiming damages of ₹ 20 lakhs.

You are required to state with reasons, how the above transactions will be dealt with in the financial statement for the year ended 31st March 2020

Solution

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

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

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

(c) Since the transfer of risk and reward and sale was complete in the month of May, 2020 when conveyance and possession got complete, no revenue should be recognised with respect to it in the financial statements of 2019-2020. However, a disclosure for the same should be given by the entity.

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

(e) The contingency is restricted to conditions existing at the balance sheet date. However, in the given case, suit was filed against the company's advertisement by a party on 10th April for amount of ₹ 20 lakhs. Therefore, it does not fit into the definition of a contingency and hence is a non-adjusting event.

Question 14 *(ICAI Study Material)*

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

Solution

As per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date" if it is likely that a contingency will result in a loss to an entity then it should create provision for that contingency on the estimated basis. Based on the above, the contention that provision for doubtful debt is not be created merely because the amount is not quantifiable is not correct. Hence Y Ltd. should make provision in the books on the basis of estimation.

Question 15 *(RTP Sep 2024)*

For five companies whose financial year ended on 31st March, 2023, the financial statements were approved by their approving authority on 15th June, 2023.

During 2023-2024, the following material events took place:

a. A Ltd. sold a major property which was included in the balance sheet at ₹ 1,00,000 and for which contracts had been exchanged on 15th March, 2023. The sale was completed on 15th May, 2023 at a price of ₹ 2,50,000.

b. On 30th April, 2023, a 100% subsidiary of B Ltd. declared a dividend of ₹ 3,00,000 in respect of its own shares for the year ended on 31st March, 2023.

c. On 31st May, 2023, the mail order activities of C Ltd. (a retail trading group) were shut down with closure costs amounting to ₹ 2.5 million.

d. On 1st July, 2023 the discovery of sand under D Ltd.'s major civil engineering contract site causes the cost of the contract to increase by 25% for. which there would be no corresponding recovery from the customer.

e. A fire, on 2nd April, 2023, completely destroyed a manufacturing plant of E Ltd. It was expected that the loss of ₹ 10 million would be fully covered by the insurance company.

You are required to state with reasons, how each of the above items numbered (a) to (e) should be dealt with in the financial statement of the various companies for the year ended 31st March, 2023.

Solution

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

(a)	A Ltd.	The sale of property should be treated as an adjusting event since contracts had been exchanged prior to the year-end. The effect of the sale would be reflected in the financial statements ended on 31.3.2023 and the profit on sale of property ₹ 1,50,000 would be treated as an extraordinary item.
(b)	B Ltd.	The declaration of dividend on 30th April, 2023 of ₹ 3,00,000 would be treated as a non-adjusting event in the financial statements of 2022-2023. This is because, the dividend has been declared after the balance sheet date and no conditions existed on the balance sheet date for such declaration of dividend. Further as per AS 9, right to receive dividend is established when it is declared and not before that.
(c)	C Ltd.	A closure not anticipated at the year-end would be treated as a non-adjusting event. Memorandum disclosure would be required for closure of mail order activities since non-disclosure would affect user's understanding of the financial statements.
(d)	D Ltd.	The event took place after the financial statements were approved by the approving authority and is thus outside the purview of AS 4. However, in view of its significance of the transaction, the directors may consider publishing a separate financial statement/ additional statement for the attention of the members in general meeting.
(e)	E Ltd.	The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, it is necessary to consider the validity of the going concern assumption having regard to the extent of insurance cover. Also, since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of a note to the financial statements.

PRACTICE QUESTIONS

Question 1 *(RTP Nov 2018) / (ICAI Study Material)*

While preparing its final accounts for the year ended 31st March, 2020, a company made provision for bad debts @ 5% of its total trade receivables. In the last week of February, 2020 a trade receivable for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2020 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 2020?

Solution

As per AS 4, Assets and Liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

A debtor for ₹ 2,00,000 suffered heavy loss due to earthquake in the last week of February, 2020 which was not covered by insurance. This information with its implications was already known to the company. The fact that he became bankrupt in April, 2020 (after the balance sheet date) is only an additional information related to the condition existing on the balance sheet date. However, bankruptcy of debtors is an adjusting event

Accordingly, full provision for bad debts amounting ₹ 2,00,000 should be made, to cover the loss arising due to the insolvency of a debtor, in the final accounts for the year ended 31st March 2020. Since the company has already made 5% provision of its total debtors, additional provision amounting ₹ 1,90,000 shall be made (2,00,000 x 95%).

Question 2

A Company entered into an agreement to sell its immovable property to another company for ₹ 35 lakhs. The property was shown in the Balance Sheet at ₹ 7 lakhs. The agreement to sell was concluded on 15th February, 2020 and sale deed was registered on 30th April, 2020. You are required to state, with reasons, how this event would be dealt with in the financial statements for the year ended 31st March, 2020.

Solution

According to 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.

In the given case, sale of immovable property was carried out before the closure of the books of accounts. This is clearly an event occurring after the balance sheet date but agreement to sell was effected on 15th February 2020 i.e. before the balance sheet date. Registration of the sale deed on 30th April, 2020, simply provides additional information relating to the conditions existing at the balance sheet date. Therefore, adjustment to assets for sale of immovable property is necessary in the financial statements for the year ended 31st March, 2020.

Question 3 *(ICAI Study Material)*

In preparing the financial statements of R Limited for the year ended 31st March, 2020 you come across the following information. How you would deal with this in the financial statements?

The company invested ₹ 100 lakhs in April, 2020 before approval of financial statements by Board of Directors in the acquisition of another company doing similar business, negotiations for which had just started during the year.

Solution

AS 4 defines "Events Occurring after the Balance Sheet Date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Approving Authority in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2020.

The disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 100 lakhs in April, 2020 for the acquisition of another company should be disclosed in the report of the Approving Authority to enable users of financial statements to make proper evaluations and decisions.

Question 4

A major fire has damaged the assets in a factory of a Limited Company on 5th April – five days after the year end and closure of accounts. The loss is estimated at ₹ 10 crores out of which ₹ 7 crores will be recoverable from the insurers.

Explain briefly how the loss should be treated in the final accounts for the previous year.

Solution

The loss due to break out of fire is an example of event occurring after the balance sheet date. The event being in the nature of a fire which is unpredictable does not relate to conditions existing at the balance sheet date. It has not affected the financial position as on the date of balance sheet and therefore requires no specific adjustments in the financial statements.

However, AS 4 states that disclosure is generally made of events occurring after balance sheet date i.e. in subsequent periods that represent unusual changes affecting the existence or substratum of the enterprise after the balance sheet date. As per the information given in the question, the earthquake has caused major destruction; therefore fundamental accounting assumption of going concern is called upon.

Considering that going concern assumption is still valid, the fact of earthquake together with an estimated loss should be disclosed.

Question 5 *(Inter Nov 2018) (5 Marks)*

The accounting year of Dee Limited ended on 31st March, 2020 but the accounts were approved on 30th April, 2020. On 15th April, 2020 a fire occurred in the factory and office premises. The loss by fire is of such a magnitude that it was not possible to expect the enterprise Dee Limited to start operation again.

State with reasons, whether the loss due to fire is an adjusting or non- adjusting event and how the fact of loss is to be disclosed by the company in the context of the provisions of AS-4.

Solution

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", an event occurring after the balance sheet date should be an adjusting event even if it does not reflect any condition existing on the balance sheet date, if the event is such as to indicate that the fundamental accounting assumption of going concern is no longer appropriate.

The fire occurred in the factory and office premises of an enterprise after 31 March, 2020 but before approval of financial statement of 30.4.2020. The loss by fire is of such a magnitude that it is not reasonable to expect the Dee Ltd. to start operations again, i.e., the going concern assumption is not valid. Since the fire occurred after 31/03/20, the loss on fire

is not a result of any condition existing on 31/03/20. But the loss due to fire is an adjusting event the entire accounts need to be prepared on a liquidation basis with adequate disclosures by the company by way of note in its financial statements in the following manner:

"Major fire occurred in the factory and office premises on 15th April, 2020 which has made impossible for the enterprise to start operations again. Therefore, the financial statements have been prepared on liquidation basis."

Question 6 *(RTP Nov 2020)*

A fire on 2nd April 2020 completely destroyed a manufacturing plant of Omega Ltd. whose financial year ended on 31st March 2020. The financial statements were approved by their approving authority on 15th June 2020. It was expected that loss of ₹ 10 million would be fully covered by the insurance company. How will you disclose it in the financial statements of Omega Ltd. for the year ended 31st March, 2020

Solution

The event is a non adjusting event since it occurred after the year end & does not relate to the conditions existing at the year end. However it is necessary to consider the validity of going concern assumption having regard to the extent of insurance cover.

Also since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of note to the financial statements.

Question 7

X Oil Ltd. closed the books of accounts on March 31, 2020 for which financial statement was finalized by the Board of Directors on September 04, 2020. During the month of December 2019, company undertook the project of laying a pipeline across the country and during May 2020 engineers realized that due to unexpected heavy rain, the total cost of the project will be inflated by ₹ 50 lakhs. How this should be provided for in the balance sheet of 2019-20 in accordance to AS 4?

Solution

This event occurred after March 31, 2020 but before September 04, 2020 is an event occurring after the balance sheet date. But this event is not affecting financial position on the date of balance sheet therefore it can be disclosed in the directors' report

Question 8 *(Inter May 2019) (5 Marks)*

The financial statements of PQ Ltd. for the year 2019-20 approved by the Board of Directors on 15th July, 2020. The following information was provided:

(a) A suit against the company's advertisement was filed by a party on 20th April, 2020, claiming damages of ₹ 25 lakhs.

(b) The terms and conditions for acquisition of business of another company have been decided by March, 2020. But the financial resources were arranged in April, 2020 and amount invested was ₹ 50 lakhs.

(c) Theft of cash of ₹ 5 lakhs by cashier on 31st March, 2020 but was detected on 16th July, 2020.

(d) Company sent a proposal to sell an immovable property for ₹ 40 lakhs in March, 2020. The book value of the property was ₹ 30 lakhs on 31st March, 2020. However, the deed was registered on 15th April, 2020.

(e) A, major fire has damaged the assets in a factory on 5th April, 2020. However, the assets are fully insured.

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

Solution

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

(b) In the given case, terms and conditions for acquisition of business were finalised and carried out before the closure of the books of accounts but transaction for payment of financial resources was effected in April, 2020. This is clearly an event occuring after the balance sheet date. Hence, necessary adjustment to assets and liabilities for acquisition of business is necessary in the financial statements for the year ended 31st March 2020.

(c) Only those significant events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustment to assets and liabilities existing on the balance sheet date or may require disclosure. In the given case, theft of cash was detected on 16th July, 2020 after approval of financial statements by the Board of Directors, hence no treatment is required.

(d) Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. In the given case, sale of immovable property was under proposal stage (negotiations also not started) on the balance sheet date. Therefore, no adjustment to assets for sale of immovable property is required in the financial statements for the year ended 31st March, 2020.

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

Question 9

State with reasons, how the following events would be dealt with in the financial statements of Hari Ltd. for the year ended 31st March, 2019 (accounts were approved on 25th July, 2019):

(1) Negotiations with another company for acquisition of its business was started on 21st January, 2019. Hari Ltd. invested ₹ 40 lakh on 22nd April, 2019.

(2) The company made a provision for bad debts @ 4% of its total debtors (as per trend followed from the previous years). In the second week of March 2019, a debtor for ₹ 2,50,000 had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In May, 2019 the debtor became bankrupt.

(3) During the year 2018-2019, Hari Ltd. was sued by a competitor for ₹ 13 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Hari Ltd. provided for a sum of ₹ 8 lakhs in its financial statements for the year ended 31st March, 2019. On 26th May, 2019, the Court decided in favour of the party alleging infringement of the trademark and ordered Hari Ltd. to pay the aggrieved party a sum of ₹ 12 lakhs.

(4) Cashier of Hari Ltd. embezzled cash amounting to ₹ 3,00,000 during March, 2019. However the same comes to the notice of Company management during August, 2019.

(5) Cheques dated 31st March, 2019 collected in the month of April, 2019. All cheques are presented to the bank in the month of April, 2019 and are also realized in the same month in the normal course after deposit in the bank.

Solution

(1) As per AS 4'Contingencies and Events Occurring After the Balance Sheet Date', disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the

financial position of the enterprise, the investment of ₹ 40 lakhs in April, 2019 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

(2) As per AS 4, adjustment to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the Balance Sheet date. A debtor for ₹ 2,50,000 suffered heavy loss due to earthquake in the second week of March, 2019 which was not covered by insurance. This information with its implications was already known to the company. The fact that he became bankrupt in May, 2019 (after the balance sheet date) is only an additional information related to the existing condition on the balance sheet date. Accordingly, full provision for bad debts amounting ₹ 2,50,000 should be made, to cover the loss arising due to the insolvency of a debtor, in the final accounts for the year ended 31st March 2019.

(3) As per AS 4, adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. In the given case, since Hari Ltd. was sued by a competitor for infringement of a trademark during the year 2018-19 for which the provision was also made by it, the decision of the Court on 26th May, 2019, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Hari Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

(4) As the embezzlement of cash comes to the notice of company management only after approval of financial statements by board of directors of the company, then the treatment will be done as per the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" and the same will not be adjusted in the financial statements for the year ended 31st March, 2019. This being an extra-ordinary item should be disclosed in the statement of profit and loss as a part of loss for the year ending March 2020, in a manner, that its impact on current profit or loss can be perceived.

(5) Collection of cheques after balance sheet date is not an adjusting event even if the cheques bear the date of 31st March. Recognition of cheques in hand is therefore not consistent with requirements of AS 4. Moreover, the collection of cheques after balance sheet date does not represent any material change or commitments affecting financial position of the enterprise and no disclosure of such collections in the Directors' Report is necessary.

Question 10 *(RTP May 2021)*

A case is going on between ABC Ltd. and Tax department on claiming the exemption for certain items, for the year 2019-2020. The court has issued the order on 15th April and rejected the claim of the company. Accordingly, company is liable to pay the additional tax. The financial statements were approved on 31st May, 2020. Shall company account for such tax in the year 2019-2020 or shall it account for in the year 2020-2021?

Solution

To decide whether, the event is adjusting or not adjusting two conditions need to be satisfied,

(a) There has to be evidence

(b) The event must have been related to period ending on reporting date.

Here both the conditions are satisfied. Court order is a conclusive evidence which has been received before approval of the financial statements since the liability is related to earlier year. The event will be considered as an adjusting event and accordingly the amount will be adjusted in accounts of 2019-2020.

Question 11 *(RTP Nov 2021)*

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

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

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

Solution

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

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

Question 12 *(Inter July 2021) (5 Marks) / (RTP May 2024)*

Surya Limited follows the financial year from April to March. It has provided the following information.

(a) A suit against the Company's Advertisement was filed by a party on 5th April, 2021, claiming damages of ₹ 5 lakhs.
(b) Company sends a proposal to sell an immovable property for ₹ 45 lakhs in March 2021. The book value of the property is ₹ 30 lakhs as on year end date. However, the Deed was registered on 15th April, 2021.
(c) The terms and conditions for acquisition of business of another company have been decided by the end of March 2021, but the financial resources were arranged in April 2021. The amount invested was ₹ 50 lakhs.
(d) Theft of cash amounting to ₹ 4 lakhs was done by the Cashier in the month of March 2021 but was detected on the next day after the Financial Statements have been approved by the Directors.

Keeping in view the provisions of AS-4, state with reasons whether the above events are to be treated as Contingencies, Adjusting Events or Non-Adjusting Events occurring after Balance Sheet date.

Solution

(a) Suit filed against the company is a contingent liability but it was not existing as on date of balance sheet date as the suit was filed on 5th April after the balance sheet date. As per AS 4, 'Contingencies' is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur. However, it may be disclosed with the nature of contingency, being a contingent liability. This event does not pertain to conditions on the balance sheet date. Hence, it will have no effect on financial statement and will be a non-adjusting event.

(b) In this case, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2021. There was just a proposal before 31st March, 2021 and hence sale cannot be shown in the financial statements for the year ended 31st March, 2021. Sale of immovable property is an event occurring after the balance sheet date is a non-adjusting event.

(c) In the given case, terms and conditions for acquisition of business were finalized before the balance sheet date and carried out before the closure of the books of accounts but transaction for payment of financial resources was effected in April, 2021.
Hence, it is an adjusting event and necessary adjustment to assets and liabilities for acquisition of business is necessary in the financial statements for the year ended 31st March 2021.

(d) Only those events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.
In the given case, as the theft of cash was detected after approval of financial statements, no adjustment is required. Hence it is non-adjusting event.

Question 13 *(Inter Dec 2021) (5 Marks)*

As per the provision of AS 4, you are required to state with reason whether the following transactions are adjusting event or non-adjusting event for the year ended 31.03.2021 in the books of NEW Ltd. (accounts of company were approved by board of directors on 10.07.2021):

a) Equity Dividend for the year 2020-21 was declared at the rate of 7% on 15.05.2021.
b) On 05.03.2021, ₹ 53,000 cash was collected from a customer but not deposited by the cashier. This fraud was detected on 22.06.2021.
c) One building got damaged due to occurrence of fire on 23.05.221. Loss was estimated to be ₹ 81,00,000.

Solution

a) If dividends are declared after the balance sheet date but before the financial statements are approved, the dividends are not recognized as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes. Thus, no liability for dividends needs to be recognized in financial statements for financial year ended 31st March, 2021 and declaration of dividend is non-adjusting event.

b) As per AS 4 'Contingencies and Events occurring after the Balance Sheet Date' an event occurring after the balance sheet date may require adjustment to the reported values of assets, liabilities, expenses or incomes if such events relate to conditions existing at the balance sheet date. In the given case, fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognize the loss. Thus, loss amounting ₹ 53,000 should be adjusted in the accounts of the company for the year ended 31st March, 2021 as it is adjusting event.

c) AS 4 states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The damage of one building due to fire did not exist on the balance sheet date i.e. 31.3.2021. Therefore, loss occurred due to fire is not to be recognized in the financial year 2020-2021 as it is non-adjusting event. However, according to the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the fire has caused major destruction; therefore, fundamental accounting assumption of going concern would have to be evaluated. Considering that the going concern assumption is still valid, the fact of fire together with an estimated loss of ₹ 81 lakhs should be disclosed in the report of the approving authority for financial year 2020-21 to enable users of financial statements to make proper evaluations and decisions.

Question 14 *(Inter Nov 2022) (5 Marks)*

MN Limited operates its business into various segments. Its financial year ended on 31st March, 2022 and financial statements were approved by their approving authority on 15th June, 2022. The following material events took place:

a) On 7th April, 2022, a fire completely destroyed a manufacturing plant of the entity. It was expected that the loss of ₹ 15 crores would be fully covered by the insurance company.

b) A claim for damage amounting to ₹ 12 crores for breach of patent had been received by the entity prior to the year end. It is the director's opinion, backed by legal advice that the claim will ultimately prove to be baseless. But it is still estimated that it would involve a considerable expenditure on legal fees.

c) A major property was sold (it was included in the balance sheet at ₹ 37,50,000) for which contracts had been exchanged on 15th March, 2022. The sale was completed on 15th May, 2022 at a price of ₹ 39,75,000.

You are required to state with reasons, how each of the above items should be dealt with in the financial statements of MN Limited for the year ended 31st March, 2022 as per AS 4.

Solution

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

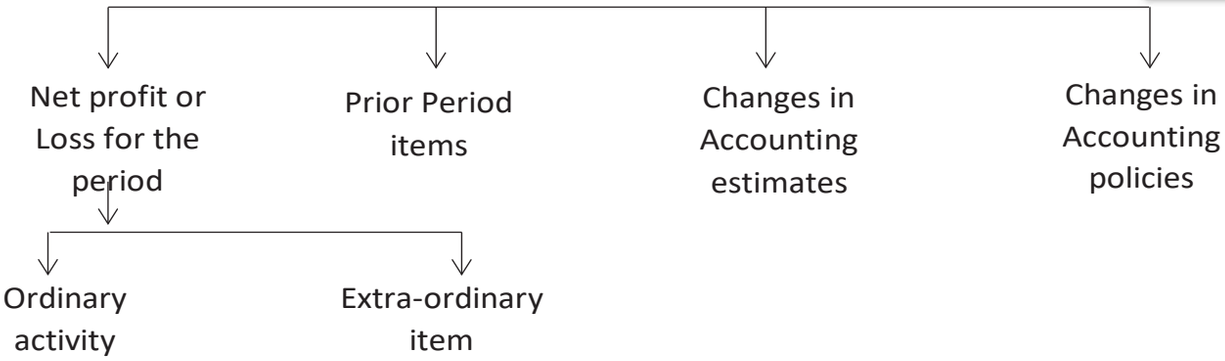
a) The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, it is necessary to consider the validity of the going concern assumption having regard to the extent of insurance cover. Also, since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of note in the financial statements.

b) On the basis of evidence provided, the claim against the company will not succeed. Thus, 12 crores should not be provided in the account but should be disclosed by means of a contingent liability with full details of the facts as per AS 29. Provision can be made for legal fee expected to be incurred to the extent that they are not expected to be recovered if the amount can be ascertained.

c) The sale of property should be treated as an adjusting event since contracts had been exchanged prior to the year-end. The effect of the sale would be reflected in the financial statements ended on 31 3.2022 and the profit on sale of property ₹ 2,25,000 would be considered.

NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS & CHANGES IN ACCOUNTING POLICIES

AS 5



NET PROFIT OR LOSS FOR THE PERIOD		
General rule	All items of income & expense which are recognized in a period should be included in the determination of Net Profit or loss for the period including extra-ordinary items, effects of changes in accounting estimates.	
Profit or loss from ordinary activity	**Meaning**	These are the principle revenue producing and generating activities and incidental items. Any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities. **For example:** Profit on sale of merchandise, loss on sale of unsold inventory at the end of the season.
	Requirement under AS-5 (PARA 12)	The nature and amount of such items is to be disclosed separately if they are of such size, nature or incidence that their disclosure is relevant to explain the performance of enterprise for the period.
	Example	➢ Writing down of inventories to NRV or vice-versa ➢ Disposal of fixed assets ➢ Disposal of long-term investments ➢ Legislative changes having retrospective effect ➢ Litigation settlements ➢ Restructuring of activities of an enterprise & reversal of provisions for the costs of restructuring.
Extra-ordinary Items	**Meaning**	These are the activities which are not ordinary. These are irregular & infrequent in nature. Only on rare occasions, an event or transactions gives rise to an extra-ordinary item.
	Requirement under AS-5 (PARA 8)	Should be disclosed in the Statement of P&L as a part of Net Profit or loss for the period.

		Their nature and amount should always be separately disclosed in the statement of P&L in a manner that its impact on current profit or loss can be perceived.
	Example	➢ Loss by earthquake, flood etc. ➢ Attachment of property of the enterprise (confiscation of property by tax officials) ➢ Government grant becoming refundable.
PRIOR PERIOD ITEM		
Meaning	These are the items of incomes and expenses which arise in the current period as a result of error or omissions in the preparation of financial statements of one or more previous periods.	
Reasons	These may occur due to: ✓ Mathematical mistakes ✓ Mistakes in applying accounting policies ✓ Due to over sight	
Requirement as per AS-5 (PARA 15)	Their nature and amount is to be separately disclosed in the Statement of P&L in such a manner that their impact on the current profit or loss can be perceived.	
Example	➢ Revenue expenditure treated as capital expenditure or vice –versa ➢ Wrong totaling of stock.	
CHANGE IN ACCOUNTING ESTIMATES		
Meaning of Accounting estimate	As a result of uncertainties inherent in business activities, many financial statement items cannot be measured with precisions but can only be estimated. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.	
Example	➢ Estimate of bad debts ➢ Useful life of depreciable assets ➢ Estimates of inventory obsolescence	
When change in accounting estimates occur	✓ As a result of new information ✓ As a result of more experience ✓ As a result of subsequent development ✓ If changes occur regarding the circumstances on which the estimate was based	
Notes	✓ It is not a prior period item ✓ The revision of the estimate by its nature does not bring the adjustments within the definitions of an extraordinary item or prior period item. ✓ The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate	

	✓ The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed *(Para 27)*
CHANGE IN ACCOUNTING POLICY	
General rule	Accounting policy once adopted should not be changed i.e. these should be applied consistently.
When is change recommended	A change in accounting policy should be made only if adoption of different accounting policy is required → By Statute i.e. by Law or → For Compliance with an Accounting standard or → If it is considered that change would result in more appropriate presentation of financial statements.
Example	➢ Change in cost formula in measuring the cost of inventories. ➢ Change of method to value PPE from Cost to Revaluation model
Disclosure requirements	✓ Any change in accounting policy having material effect is to be disclosed. ✓ If the effect of such change is material it should be shown in financial statement of the period in which such change is made. ✓ Where effect of change is not ascertainable, fact should be disclosed. ✓ If the impact of such change is not material in current period but is expected in later periods, then the fact of change is to be disclosed.
Notes	Sometimes it is difficult to distinguish between a change in accounting policy and a change in accounting estimate. In such cases, the change is treated as "change in accounting estimate" with appropriate disclosure. *The following are not changes in accounting policies*: o The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of formal retirement gratuity scheme by an employer in place of adhoc ex-gratia payments to employees on retirement. o The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

ASSIGNMENT QUESTIONS

Question 1

Give two examples on each of the following items:

a) Change in Accounting Policy
b) Change in Accounting Estimate
c) Extra Ordinary Items
d) Prior Period Items.

Solution

a) Examples of Changes in Accounting Policy:
   (i) Change of method to value PPE from Cost to Revaluation model.
   (ii) Change in cost formula in measuring the cost of inventories.

b) Examples of Changes in Accounting Estimates:
   (i) Change in estimate of provision for doubtful debts on sundry debtors.
   (ii) Change in estimate of useful life of fixed assets.

c) Examples of Extraordinary items:
   (i) Loss due to earthquakes / fire / strike
   (ii) Attachment of property of the enterprise by government

d) Examples of Prior period items:
   (i) Applying incorrect rate of depreciation in one or more prior periods.
   (ii) Omission to account for income or expenditure in one or more prior periods.

Question 2 *(ICAI Study Material)*

The company finds that the inventory sheets of 31.3.2019 did not include two pages containing details of inventory worth ₹14.5 lakhs. State, how you will deal with the following matters in the accounts of Pure Ltd. for the year ended 31st March, 2020.

Solution

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

Rectification of error in inventory valuation is a prior period item as per AS 5. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

Question 3 *(ICAI Study Material)*

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 2012 to September, 2018 has been received and paid in February, 2019. However, the same was accounted in the year 2019-20. Comment on the accounting treatment done in the said case.

Solution

The final bill having been paid in February, 2019 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2019. However it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2019, this material charge has arisen in the current period i.e., year ended 31st March, 2020. Therefore it should be treated as 'Prior period item' as per AS 5.

As per AS 5, prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement

of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss. It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify extraordinary item as per AS 5.
For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.'

Question 4 *(Inter May 2018 (5 Marks) / RTP May 2019)*

PQR Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2020. The company seeks your advice on the following:

(i) Goods worth ₹ 5,00,000 were destroyed due to flood in September, 2017. A claim was lodged with insurance company. But no entry was passed in the books for insurance claim in the financial year 2017-18. In March, 2020, the claim was passed and the company received a payment of ₹ 3,50,000 against the claim. Explain the treatment of such receipt in final account for the year ended 31st March, 2020.

(ii) Company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2019-20. Subsequently, on a review of the credit period allowed and financial capacity of the customers, the company decides to increase the provision to 8% on debtors as on 31.03.2020. The accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard, can this revision be considered as an extra ordinary item or prior period item?

Solution

(i) As per the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses, which arise, in the current period as a result of error or omissions in the preparation of financial statements of one or more prior periods. Further, 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 current profit or loss can be perceived.
In the given instance, it is clearly a case of error/omission in preparation of financial statements for the year 2017-18. Hence, claim received in the financial year 2019-20 is a prior period item and should be separately disclosed in the statement of Profit and Loss.

(ii) In the given case, a limited company created 2.5% provision for doubtful debts for the year 2019-2020. Subsequently, the company revised the estimates based on the changed circumstances and wants to create 8% provision.
As per AS 5, the revision in rate of provision for doubtful debts will be considered as change in estimate and is neither a prior period item nor an extraordinary item.
The effect of such change should be shown in the profit & loss account for the year ending 31st March, 2020

Question 5

S.T.B. Ltd. makes provision for expenses worth ₹ 7,00,000 for the year ending March 31, 2019, but the actual expenses during the year ending March 31, 2020 comes to ₹ 9,00,000 against provision made during the last year. State with reasons whether difference of ₹ 2,00,000 is to be treated as prior period item as per AS-5.

Solution

As per AS 5, as a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation

process involves judgments based on the latest information available. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Estimates may have to be revised, if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments.

As per the standard, the effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate. Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Thus, revision of an estimate by its nature i.e. the difference of ₹ 2 lakhs, is not a prior period item.

Therefore, in the given case expenses amounting ₹ 2,00,000 (i.e. ₹ 9,00,000 – ₹ 7,00,000) relating to the previous year recorded in the current year, should not be regarded as prior period item.

Question 6

X Co. Ltd. signed an agreement with its employees union for revision of wages in June, 2020. The wage revision is with retrospective effect from 1.4.2016. The arrear wages upto 31.3.2020 amounts to ₹ 80 lakhs. Arrear wages for the period from 1.4.2020 to 30.06.2020 (being the date of agreement) amounts to ₹ 7 lakhs. Decide whether a separate disclosure of arrear wages is required.

Solution

It is given that revision of wages took place in June, 2020 with retrospective effect from 1.4.2016. The arrear wages payable for the period from 1.4.2016 to 31.3.2020 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 1.4.2016 to 30.6.2020) should be included in current year's wages. It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item.

However, as per para 12 of AS 5,' 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 1.4.2020 to 30.6.2020) amounting ₹ 7 lakhs is not a prior period item hence need not be disclosed separately. This may be shown as current year's wages.

Question 7

An extract from the statement profit and loss of a company for 2019-20 is given below:

	₹ '000	₹ '000
Sales		3,000
Opening stock	500	
Production cost	2,800	
	3,300	
Less: Closing Stock	(600)	(2,700)
Gross Profit		300

Expenses		(250)
Profit before tax		50
Tax		(20)
Profit after tax		30

Closing stock includes stock damaged in a fire in 2018-19. On 31/03/19, estimated net realisable value of this stock was ₹ 15,000. The revised estimate of net realisable value included in closing stock of 2019-20 is ₹ 5,000. Rewrite statement of profit & loss if necessary to comply with requirements of AS 5.

Question 8

Closing Stock for the year ending on 31st March, 2020 is ₹ 1,50,000 which includes stock damaged in a fire in 2018-19. On 31st March, 2019, 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 2019-20 is ₹ 4,000. Find the value of closing stock to be shown in Profit and Loss Account for the year 2019-20, using provisions of Accounting Standard 5.

Solution

The fall in estimated net realisable value of damaged stock ₹ 8,000 is the effect of change in accounting estimate. As per AS 5, 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 31.3.2019, i.e. difference of cost and NRV was shown in the profit and loss account as an extra-ordinary item. Therefore, in the year 2019-20, revision in accounting estimate should also be classified as extra-ordinary item 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 2019-20 will be as follows:

Closing Stock (including damaged goods)	1,50,000
Less: Revised value of damaged goods	(4,000)
Closing stock (excluding damaged goods)	1,46,000

Question 9 *(RTP May 2018)/ (RTP Nov 2022)*

Bela Ltd. has a vacant land measuring 20,000 sq. mts, which it had no intention to use in the future. The Company decided to sell the land to tide over its liquidity problems and made a profit of ₹10 Lakhs by selling the said land. There was a fire in the factory and a part of the unused factory shed valued at ₹ 8 Lakhs was destroyed. The loss from fire was set off against the profit from sale of land and profit of ₹2 lakhs was disclosed as net profit from sale of assets. Do you agree with the treatment and disclosure? If not, state your views.

Solution

As per para 8 of AS 5, Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

In the given case the selling of land to tide over liquidation problems as well as fire in the Factory does not constitute ordinary activities of the Company. These items are distinct from the ordinary activities of the business. Both the events are material in nature and expected not to recur frequently or regularly. Thus, these are Extraordinary Items.

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

Question 10 *(ICAI Study Material)/ (RTP May 2020) / (RTP Sep 2024)*

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

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

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

Solution

As per AS 5, the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

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

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

Question 11 *(RTP Nov 2018) / (RTP Nov 2019) / (RTP Nov 2020) (Similar)/ (RTP May 2022)*

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

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

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

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

(d) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.
(e) During the year ended 31st March, 2020, there was change in cost formula in measuring the cost of inventories

Solution

(a) In the given case, Mobile limited created 2% provision for doubtful debts till 31st March, 2019. Subsequently in 2019-20, the company revised the estimates based on the changed circumstances and wants to create 3% provision. Thus change in rate of provision of doubtful debt is change in estimate and is not change in accounting policy. This change will affect only current year.
(b) As per AS 5, the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is a transaction which is substantially different from the previous policy, will not be treated as change in an accounting policy.
(c) Change in useful life of furniture from 5 years to 3 years is a change in estimate and is not a change in accounting policy.
(d) Adoption of a new accounting policy for events or transactions which did not occur previously should not be treated as a change in an accounting policy. Hence the introduction of new pension scheme is not a change in accounting policy.
(e) Change in cost formula used in measurement of cost of inventories is a change in accounting policy.

Question 12 *(RTP Jan 2025)*

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

Solution

The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The balance amount left in the provision created earlier is not as a result of error in the past. So it will not be considered as prior period item. Such write back of provision is not an ordinary feature of the business, it shall be considered as an extra-ordinary item.

As per paragraph 8 of AS 5, extraordinary items should be disclosed in the Statement of Profit and Loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the Statement of Profit and Loss in a manner that its impact on current profit or loss can be perceived. Hence, the amount so written-back (if material) should be disclosed as an extraordinary item as per AS 5 rather than as prior period items.

Question 13 *(ICAI Study Material)*

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

treated the amount of ₹ 50,000 written off as a prior period item and made the adjustments accordingly. The company is of the view that since sundry balances were recognized in the prior period(s), its related written-off amount should be treated as a prior period item.

Solution

No, the company is not correct in treating the amount written off as a prior period item.
As per AS 5, prior period items are income or expenses which arise in a current year due to errors or omissions in the preparation of the financial statements of one or more prior period(s). Writing off an old outstanding balance in the current year which is appearing in its books of accounts from the past 5 financial years does not mean that there has been an error or omission in the preparation of financial statements of prior period(s).
It is just a practice adopted by the company to write off the old outstanding balances of more than 5 years in its current year books of accounts. Therefore, the amount written off is not treated as a prior period item.
Hence, adjusting the amount ₹50,000 written off as a prior period item on the basis that sundry balances were recognized in prior period(s) is not in line with AS 5.

Question 14 *(Inter Nov 2023) (5 Marks)*

The accountant of Beryl Limited has asked you to identify the following items as - Change in Accounting Policies / Change in Accounting Estimates / Extraordinary Items / Prior period items / Ordinary Activity.

(i) Non-provision for salary already due in earlier year.
(ii) Attachment of the property of the enterprise.
(iii) Introduction of new pension scheme for employees.
(iv) Change in Reserve for obsolete inventory.
(v) Settlement of litigation case.
(vi) Actual Bad debts exceed the provision.
(vii) Legislative changes having long term retrospective application.
(viii) Capitalisation of working capital loan interest.
(ix) Change from Cost Model to Revaluation Model for measurement of carrying amount of PPE.
(x) Government sanctioned grant in current year for expenses incurred in previous accounting year.

Solution

(i) Prior Period item
(ii) Attachment of property of enterprise is an extraordinary item.
(iii) Introduction of new pension scheme for employes is not a change in accounting policy. It is an ordinary activity.
(iv) Change in provision for obsolete inventory is a change in accounting estimate.
(v) Litigation settlement is an ordinary activity but requires separate disclosure
(vi) Change in estimate
(vii) Ordinary activity requiring separate disclosure
(viii) Error*
(ix) Change in Accounting policy.
(x) Ordinary activity requiring separate disclosure or extra-ordinary item.

*If it relates to the previous year then it can be considered as a prior period item.

PRACTICE QUESTIONS

Question 1 *(Inter May 2019) (2 Marks)*

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

(1) As per the provisions of AS-5, extraordinary items should not be disclosed in the statement of profit and loss as a part of net profit or loss for the period.

(2) As per the provisions of AS-4, a contingency is a condition or situation, the ultimate outcome of which (gain or loss) will be known or determined only on the occurrence of one or more uncertain future events.

Solution

(1) **False:** The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived

(2) **False**: A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events

Question 2 *(ICAI Study Material)*

(i) During the year 2019-2020, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?

(ii) A company signed an agreement with the Employees Union on 1.10.2019 for revision of wages with retrospective effect from 30.9.2018. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2019-20?

Solution

(i) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that: "When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately."

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

(ii) It is given that revision of wages took place on 1st October, 2019 with retrospective effect from 30.9.2018. Therefore wages payable for the half year from 1.10.2019 to 31.3.2020 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item. Additional wages liability of ₹ 7,50,000 (for 1½ years @ ₹ 5,00,000 per annum) should be included in current year's wages. It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Such an expense does not qualify as an extraordinary item. However, as per AS 5, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Question 3 *(Inter May 2022) (5 Marks)*

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

Solution

As per AS 5, prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances which though related to prior periods, are determined in the current period.
It is given that revision of wages took place in April, 2022 with retrospective effect from 1st January, 2022. Therefore, wages payable for the period from 1.01.2022 to 31.3.2022 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item. The full amount of wages payable to workers will be treated as an expense of current year and it will be charged to profit & loss account for the year 2022-23 as normal expenses.
It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Such an expense does not qualify as an extraordinary item. Therefore, finance manager is incorrect in treating increase as extraordinary item. However, as per AS 5, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature & amount of such items should be disclosed separately. Therefore, additional wages liability of ₹ 30 lakhs should be disclosed separately in the financial statements of TQ Cycles Ltd. for the year ended 31st March, 2023.

Question 4

Shama was working with ABC Ltd. drawing monthly salary of ₹ 25,000 per month. She went on maternity leave with pay for 7 months i.e. from 1-01-2019 to 31-7-19. Her salary for 3 months was not provided for in financial statements for F.Y. 2018-19 due to omission. When she joined after leave period, the whole salary for 7 months was paid to her.
You are required to:

(i) Pass the necessary journal entries in F.Y. 2019-20 to record the above transaction as per accounting standard-5 and state reason for the same.

(ii) Would the treatment have been different, if Shama was terminated on 01-01-2019 and was reinstated in service by the court w.e.f. 01-08-2019 with instruction to pay Shama salary for the intervening period i.e. 1-01-2019 to 31-07-2019

Solution

As per AS 5, the term 'prior period items', refers to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss so that their impact on the current profit or loss can be perceived. Hence, in this case salary paid to Shama for 3 months i.e 1.1.2019 to 31.3.2019 ₹ 75,000 will be classified as prior period item in FY 2019-20 and following journal entry shall be passed:

(i) **Journal entry in FY 2019-20**

Salary A/c (₹ 25,000 x 4)	Dr.	1,00,000	
Prior period item (₹ 25,000 x 3)	Dr.	75,000	
To Bank A/c			1,75,000

(Salary related to 7 months paid out of which 3'months' salary is prior period item)

Alternative Entry

Salary A/c (prior period item)	Dr.	75,000	
To Bank A/c			75,000

(Salary related to 3 months i.e. January, 2019 to March 2019 paid in 2019-2020)

Salary A/c	Dr.	1,00,000	
To Bank A/c			1,00,000

(Salary related to 4 months paid on 1.8.2019 for April to July, 2019)

(ii) AS 5 inter alia states that the term 'prior period items' does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period. Accordingly, in the second case though Shama was terminated on 1.1.2019 i.e. in 2018-2019, yet she was reinstated due to court's order in 2019-2020, with the instruction by the court to pay the salary for the intervening period i.e. with retrospective effect from January, 2019. The adjustment of salary of ₹ 75,000 (for January 2019 to March, 2019) would not be considered as prior period item and will be accounted for in the books as current year expense. Thus the entire amount of Salary of ₹ 1,75,000 for January, 2019 to July, 2019 is a current year expense only.

Salary A/c (₹ 25,000 x 7)	Dr.	1,75,000	
To Bank A/c			1,75,000

(Salary related to 7 months paid i.e. for the period 1.1.2019 to 31.7.2019)

Question 5 *(RTP Nov 2021)*

a) There was a major theft of stores valued at ₹ 10 lakhs in the preceding year which was detected only during current financial year (2020-2021). How will you deal with this information in preparing financial statements of R Ltd. for the year ended 31st March, 2021.

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

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

Solution

a) Due to major theft of stores in the preceding year (2019-2020) which was detected only during the current financial year (2020–2021), there was overstatement of closing inventory of stores in the preceding year. This must have also resulted in the overstatement of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year as 'Prior Period Items' as per AS 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. Accordingly, the adjustments relating to both opening inventory of the current year and profit brought forward from the previous year should be separately disclosed in the statement of profit and loss together with their nature and amount in a manner that their impact on the current profit or loss can be perceived. Alternatively, it may be assumed that in the preceding year, the value of inventory of stores as found out by physical verification of inventories was considered in the preparation of financial statements of the preceding year. In such a case, only the disclosure as to the theft and the resulting loss is required in the notes to the accounts for the current year i.e, year ended 31st March, 2021.

b) As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Accordingly, the adoption of a new accounting policy of paying pension to retired employees is a policy for events or transactions which did not occur previously. Hence, it will not be treated as a change in an accounting policy.

Question 6 *(ICAI Study Material)*

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

Solution

No. As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

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

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

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

Question 7 – *(Inter Nov 2022) (5 Marks)*

The Accountant of Shiva Limited had sought your opinion with relevant reasons, whether the following transactions will be treated as change in Accounting Policies or change in Accounting Estimates for the year ended 31st March, 2021. Please advise him in the following situations in accordance with the provisions of AS 5:

a) Provision for doubtful debts was created @3% till 31st March, 2020. From the Financial year 2020-2021, the rate of provision has been changed to 4%.
b) During the year ended 31st March,2021, the management has introduced a formal gratuity scheme in place of ad-hoc ex-gratia payments to employees on retirement.
c) Till 31st March, 2020 furniture was depreciated on straight line basis over a period of 5 years. From Financial year 2020-2021, useful life of furniture has been changed to 3 years.
d) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.
e) During the year ended 31st March 2021, there was change in cost formula in measuring the cost of inventories.

Solution

a) In the given case, company has created 3% provision for doubtful debts till 31st March, 2020. Subsequently from 1st April, 2020, the company revised the estimates based on the changed circumstances and wants to create 4% provision. Thus, change in rate of provision of doubtful debt is change in estimate and is not change in accounting policy. This change will affect only current year.

b) As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is a transaction which is substantially different from the previous transaction, will neither be treated as change in an accounting policy nor change in accounting estimate.

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

d) Adoption of a new accounting policy for events or transactions which did not occur previously should not be treated as a change in an accounting policy. Hence the introduction of new pension scheme is neither a change in accounting policy nor a change in accounting estimate.

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

Question 8 *(Inter Jan 2021) (5 Marks) / (RTP May 2023)*

State whether the following items are examples of change in Accounting Policy / Change in Accounting Estimates / Extraordinary items / Prior period items / Ordinary Activity:

(i) Actual bad debts turning out to be more than provisions.
(ii) Change from Cost model to Revaluation model for measurement of carrying amount of PPE.
(iii) Government grant receivable as compensation for expenses incurred in previous accounting period.
(iv) Treating operating lease as finance lease.
(v) Capitalisation of borrowing cost on working capital.
(vi) Legislative changes having long term retrospective application.
(vii) Change in the method of depreciation from straight line to WDV.
(viii) Government grant becoming refundable.
(ix) Applying 10% depreciation instead of 15% on furniture.
(x) Change in useful life of fixed assets.

Solution

(i) Change in Accounting Estimates
(ii) Change in Accounting Policy
(iii) Extra -ordinary Items
(iv) Prior- period Items
(v) Prior-period Items (as interest on working capital loans is not eligible for capitalization)
(vi) Ordinary Activity
(vii) Change in Accounting Estimates
(viii) Extra -ordinary Items
(ix) Prior- period Items
(x) Change in Accounting Estimates

Question 9 *(ICAI Study Material)*

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

Solution

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

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

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

CONSTRUCTION CONTRACTS

AS 7

<table>
<tr><td>Objective</td><td colspan="2">To prescribe accounting for revenue and costs associated with construction contracts</td></tr>
<tr><td>Scope</td><td colspan="2">Accounting for construction contracts in the financial statements of <u>contractors</u> (not contractee)</td></tr>
<tr><td>Meaning of construction contract</td><td colspan="2">It is a contract specifically negotiated for
→ construction of an asset
<u>Example:</u> Bridge, Building, Dam, etc.
→ Combination of assets that are closely interrelated or interdependent in terms of design, technology, function or ultimate purpose or use.
<u>Example:</u> Refineries, Other complex pieces of plant or equipment etc.

Construction contracts also include:
(a) contracts for rendering of services which are directly related to construction of the asset, for eg., those for the services of project managers & architects;
(b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.</td></tr>
<tr><td rowspan="2">Types of construction Contracts:</td><td>Fixed price contract</td><td>In this contract, the contractor agrees to fixed contract price or fixed rate per unit of output. It may be with or without escalation clause</td></tr>
<tr><td>Cost plus contract</td><td>In this contract, the contractor is reimbursed for the cost incurred plus percentage of these costs or fixed fee.
<table><tr><td>Cost incurred (allowable/defined cost)</td><td>XX</td></tr><tr><td>+% of cost or fixed fee</td><td><u>XX</u></td></tr><tr><td></td><td>XX</td></tr></table></td></tr>
<tr><td>Contract revenue</td><td colspan="2">It means the revenue which is agreed upon between the contractor and contractee
<table><tr><td>Initial contract revenue</td><td>XX</td></tr><tr><td>+/- Variations (alteration in job like change in specifications)*</td><td>XX</td></tr><tr><td>+ Incentive payments (price for timely completion of job)**</td><td>XX</td></tr><tr><td>+ Price escalation (extra compensation for increased cost)</td><td>XX</td></tr><tr><td>+ Claims (losses in contract due to contractee like customer caused delays, error in specification or design etc.</td><td>XX</td></tr><tr><td>Any penalty (from delays caused by contractor)</td><td>(XX)</td></tr><tr><td>Contract Revenue</td><td>XX</td></tr></table>
* included in contract revenue when it is probable that the customer will approve the variation and amount of revenue arising from the variation;
**included in contract revenue when the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded;
<u>These should be included in contract revenue if it is probable that they will result in revenue & they are capable of being reliably measured.</u></td></tr>
</table>

Contract cost	It means the expenses incurred at site along with the apportioned contract cost	
	Direct cost	Relate directly to specific contract ***Example***: Site labour cost, cost of material used, depreciation of plant and equipment, etc.
	Allocated cost	Attributable to contract in general and can be allocated ***Example***: Insurance of machinery, salary of supervisor who is supervising more than 1 contract, etc.
	Specific cost	Specifically chargeable to customer under the terms of contract ***Example***: General administration cost and development cost for which reimbursement is specified under contract
	Note	Direct cost may be reduced by any incidental income that is not included in contract revenue ***Example***: Income from sale of surplus material and disposal of plant & equipment at the end of contract.
	Exclusions	• general administration & research & development costs for which reimbursement is not specified in the contract • selling costs • depreciation of idle plant and equipment that is not used on a particular contract
Recognition of contract revenue and expenses	**When to recognize**	When the outcome of construction contract can be estimated reliably
	Conditions	❖ Total contract revenue can be measured reliably ❖ It is probable that economic benefits associated with contract will flow to the enterprise ❖ Contract cost can be clearly identified and measured reliably.
	Basis of recognition	By reference to the stage of completion of the contract activity at the reporting date. **Methods to determine stage of completion of contract** 1. % completion = Costs till date / Total Estimated Costs x 100 2. Survey of work performed (Certification by surveyor) 3. Completion of a physical proportion of the contract work. (**Example**: Contract to place tiles)
Computation of Profit	Contract Revenue x Stage of Completion (%) = XXX Less: Contract Costs till date = (XXX) Total Profit till date = XXX Less: Profit recognized till last year = (XXX) Profit for the Current Year = **XXX**	
Recognition of expected losses	**Para 35**	When it is probable that Total contract cost will exceed Total contract revenue, Expected loss should be recognized as expense immediately.

	Para 36	Amount of such loss is determined irrespective of ❖ Whether or not work has commenced on the contract. ❖ Stage of completion of contract activity ❖ Amount of profits expected to realize on other contracts which are not treated as single construction contract
Outcome of construction contract cannot be estimated reliably	❖ Revenue should be recognized only to the extent of contract costs incurred of which recovery is probable; and ❖ Contract costs should be recognised as expense in the period in which they are incurred.	
Combining & Segmenting Construction Contracts (CONDITIONS)	**Separate**	❖ separate proposals have been submitted ❖ separate negotiations have been carried out and contractor & customer can accept or reject part of it. ❖ costs and revenue of each asset can be separately identified
	Combining	❖ they are negotiated as a single package; ❖ they are closely interrelated and ❖ they will be performed concurrently i.e. in sequence
Construction of an additional asset	It should be treated as a separate construction contract when: ➢ the asset differs significantly in design, technology or function from the asset covered by the original contract; or ➢ the price of the asset is negotiated without regard to the original contract price	
Treatment of Costs Relating to Future Activity	The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.	
Uncollectable Contract Revenue	When an uncertainty arises about the collectability of an amount already included in contract revenue, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue	
Change in estimates	The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract cost. Therefore, the effect of a change in estimates is accounted for as change in accounting estimate as per AS-5 (Prospective effect).	
Disclosure requirements	❖ Amount of contract revenue recognized ❖ Method used to determine such revenue ❖ Method used to determine stage of completion of contract in progress. ❖ Following to be disclosed for contract in progress: • Aggregate cost incurred • Profit recognized till date • Advance received • Amount of retention • Progress Billings An enterprise should also present: a) the gross amount due from customers for contract work as an asset & b) the gross amount due to customers for contract work as a liability	

ASSIGNMENT QUESTIONS

Question 1 *(RTP May 2020) / (ICAI Study Material)* *Pg no.*_____

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 a 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 upto 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 2 *(RTP May 2018) / (Nov 2018) / (Nov 2020) / (Jan 2025)* *Pg no.*_____

Uday Constructions undertake to construct a·bridge for the Government of Uttar Pradesh. The construction commenced during the financial year ending 31.03.2020 and is likely to be completed by the next financial year. The contract is for a fixed price of ₹ 12 crores with an escalation clause. The costs to complete the whole contract are estimated at ₹ 9.50 crores of rupees.

You are given the following information for the year ended 31.03.2020:

Cost incurred upto 31.03.2020, ₹ 4 crores

Cost estimated to complete the contract ₹ 6 crores

Escalation in cost by 5% and accordingly the contract price· is increased by 5%.

You are required to ascertain the state of completion and state the revenue and profit to be recognized for the year as per AS-7.

Question 3 *(ICAI Study Material)* *Pg no.*_____

RT Enterprises has entered into a fixed price contract for construction of a tower with its customer. Initial tender price agreed is ₹ 220 crore. At the start of the contract, it is estimated that total costs to be incurred will be ₹ 200 crore. At the end of year 1, this estimate stands revised to ₹ 202 crore. Assume that the construction is expected to be completed in 3 years. During year 2, the customer has requested for a variation in the contract. As a result of that, the total contract value will increase by ₹ 5 crore and the costs will increase by ₹ 3 crore.

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

Year 1: ₹ 52.52 crore

Year 2: ₹ 154.20 crore (including unused material of 2.5 crore)

Year 3: ₹ 205 crore.

You are required to calculate:

(a) Stage of completion for each year.

(b) Profit to be recognised for each year.

Question 4 *(Inter July 2021) (5 Marks) / (RTP May 2024)* Pg no._____

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

(i) Contract Price - ₹ 85 lakhs
(ii) Materials issued - ₹ 21 Lakhs out of which Materials costing ₹ 4 Lakhs is still lying unused at the end of the period.
(iii) Labour Expense for workers engaged at site 16 Lakhs (out of which 1 Lakh is still unpaid)
(iv) Specific Contract Costs - ₹ 5 Lakhs
(v) SubContract Costs for work executed 7 Lakhs, Advances paid to subcontractors 4 Lakhs
(vi) Further Cost estimated to be incurred to complete the contract - ₹ 35 Lakhs

You are required to compute the Percentage of Completion, the Contract Revenue and Cost to be recognized as per AS-7.

Solution

Computation of contract cost

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

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

Contract revenue and costs to be recognized

Contract revenue (₹ 85,00,000 x 56.25%) = ₹ 47,81,250 Contract costs = ₹45,00,000

Question 5 *(ICAI Study Material)* Pg no._____

AB contactors enters into a contract on 1st January 2021 with XY to construct a 5- storied building. Under the contract, AB is required to complete the construction in 3 years (i.e., by 31st December 2023). The following information is relevant:

Fixed price (agreed) ₹5 crore
Material cost escalation (to the extent of 20% of increase in material cost)
Labour cost escalation (up to 30% of increase in minimum wages)

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

Labour cost was originally estimated to be ₹1.20 crore (based on initial minimum wages). However, the costs have increased by 25% during the construction period. Material costs have increased by 40% due to short-supply. The total increase in material cost due to the 40% escalation is ₹80 lakh.

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

Assume that in year 2022, XY has requested AB to increase the scope of the contract. An additional floor is required to be constructed and there is an increase in contract fee by ₹1 crore. AB has incurred a cost of ₹20 lakh for getting the local authority approvals which it will be entitled to claim from XY in addition to the increase in the fixed fee.

Also measure the total contract revenue in this case.

Question 6 *(RTP Nov 2021)* *Pg no.*_____

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

Solution

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

Incentive payments are included in contract revenue when:

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

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

In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract

Question 7 *(ICAI Study Material)* *Pg no.*_____

X Ltd. commenced a construction contract on 01/04/19. The fixed contract price agreed was ₹ 2,00,000. The company incurred ₹ 81,000 in 2019-20 for 45% work and received ₹ 79,000 as progress payment from the customer. The cost incurred in 2020-21 was ₹ 89,000 to complete the rest of work. Prepare P&L Account extract and Customer's Account for 2 years.

Question 8 *(ICAI Study Material)* *Pg no.*_____

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

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

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

Question 9 *(ICAI Study Material)* *Pg no.*_____

On 1st December, 2019, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2020 the company found that it had already spent ₹ 64,99,000 on construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be recognised in the statement of profit and loss for the year ended 31st March, 2020 as per provisions of Accounting Standard 7 (Revised)?

Question 10 *(ICAI Study Material)* *Pg no.*_____

Akar Ltd. Signed on 01/04/19, a construction contract for ₹ 1,50,00,000.

Following particulars are extracted in respect of contract, for the period ending 31/03/20.

- Materials used ₹ 71,00,000
- Labour charges paid ₹ 36,00,000
- Hire charges of plant ₹10,00,000
- Other contract cost incurred ₹ 15,00,000
- Labour charges of ₹ 2,00,000 are still outstanding on 31.3.20.

- ❖ 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 any provision for foreseeable loss to be recognised as per AS-7.

Question 11 *(ICAI Study Material)* *Pg no.*_____

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2020.

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

Firm seeks your advice & assistance in presentation of accounts keeping in view the requirements of AS 7.

Question 12 *Pg no.*_____

An amount of ₹9,90,000 was incurred on a contract work upto 31–3–2020. Certificates have been received to date to the value of ₹12,00,000 against which ₹10,80,000 has been received in cash. The cost of work done but not certified amounted to ₹22,500. It is estimated that by spending and additional amount of ₹60,000 (including provision for contingencies) the work can be completed in all respects in another two months. The agreed contract price of work is ₹ 12,50,000. Compute a conservative estimate of the profit to be taken to the Profit and Loss Account as per AS–7.

Question 13 *(ICAI Study Material)* *Pg no.*_____

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

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

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

Solution

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

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

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

Question 14 *(ICAI Study Material)* *Pg no.*_____

X Ltd. commenced a construction contract on 01/04/19. The contract price agreed was reimbursable cost plus 10%. The company incurred ₹ 1,00,000 in 2019-20, of which ₹ 90,000 is

reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at ₹ 5,000. The other costs to complete the contract could not be estimated reliably. Show the P&L A/c extract.

Question 15 *(RTP May 2019)* *Pg no.*_____

GTI Ltd. negotiates with Bharat Oil Corporation Ltd. (BOCL), for construction of "Retail Petrol & Diesel Outlet Stations". Based on proposals submitted to different Regional Offices of BOCL, the final approval for one outlet each in Region X, Region Y, Region Z is awarded to GTI Ltd. A single agreement is entered into between two. The agreement lays down values for each of the three outlets i.e. ₹102 lacs, ₹150 lacs, ₹130 lacs for Region X, Region Y, Region Z respectively. Agreement also lays down completion time for each Region.
Comment whether GTI Ltd. will treat it as single contract or three separate contracts with reference to AS-7?

Solution

As per AS 7 'Construction Contracts', when a contract covers number of assets, the construction of each asset should be treated as a separate construction contract when:

a) separate proposals have been submitted for each asset;
b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
c) the costs and revenues of each asset can be identified.

In the given case, each outlet is submitted as a separate proposal to different Zonal Offices, which can be separately negotiated, and costs and revenues thereof can be separately identified. Hence, each asset will be treated as a "separate contract" even if there is one single agreement for contracts.
Therefore, three separate contract accounts must be recorded and maintained in the books of GTI Ltd. For each contract, principles of revenue and cost recognition must be applied separately and net income will be determined for each asset as per AS 7.

PRACTICE QUESTIONS

Question 1 *(RTP Sep 2024)* *Pg no._____*

Mehta ltd. has undertaken bridge construction contract where in, bridge will be constructed in 3 years. The details of the contracts are as follows:

(i) Initial contract revenue ₹ 900 crore (ii) Initial contract cost ₹ 800 crore

	Year I	Year II	Year III
	₹ in crore	₹ in crore	₹ in crore
Estimated contract cost	805		
Increase in contract revenue	-	20	
Estimated additional increase cost	-	15	
Contract cost incurred upto	161	584	820

At the end of year II, cost incurred includes ₹ 10 crore, for material stored at the sites to be used in year III to complete the project.

State the amount of revenue, expenses and profit to be recognized in the Statement of Profit and Loss in these three years.

Solution

Statement showing analysis of the contract details

(₹ in crore)

		Year I	Year II	Year III
(a)	Initial revenue agreed	900	900	900
(b)	Increase in contract revenue	-	20	20
(c)	Total Contract Value	900	920	920
(d)	Contract cost incurred up to the date of reporting	161	574 (excluding 10)*	820
(e)	Total estimated contract	805	820(805+15)	820
(f)	Stage of Completion	20%	70%	100%
	[(d/e) x 100)]	(161/805 x 100)	(574/820 x 100)	(820/820 x 100)

* **Note**: 10 crore, for material stored at the sites to be used in III year. i.e. in IInd year it is already included so it will be deducted in II year only.

Statement showing amount of revenue, expenses and profit to be recognized in the Statement of Profit and Loss in three years.

(₹ in crore)

	Upto reporting date	Recognised in the prior year	Recognized in the current year
Year I			
Revenue (900 x 20/100)	180	-	180
Expenses	161	-	161
Profit	19	-	19
Year II			
Revenue (920 x 70/100)	644	180	464
Expenses (820 x 70/100)	574	161	413
Profit	70	19	51
Year III			
Revenue	920	644	276
Expenses	820	574	246
Profit	100	70	30

Question 2 *(Inter May 2024) (7 Marks)* *Pg no._____*

Constructions Limited is engaged in the business of constructing Flyovers and Railway over bridges. It obtained a contract from Railway Authorities to construct a railway over bridge for ₹ 400 crores. The construction of the railway over bridge is expected to be completed in 4 years.

At the outset of the contract, it was estimated that the total costs to be incurred will be ₹ 370 crores but by the end of year 1, this estimate stands revised to ₹ 375 crores.

During year 3, the Construction Limited has requested for a variation in the contract which is approved by Railway Authorities and accordingly the total contract value will increase by ₹ 10 crores and costs will increase by ₹ 7 crores.

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

Year 1 ₹ 98.8 crores
Year 2 ₹ 202.4 crores
Year 3 ₹ 310 crores (including unused material of 3 crores)
Year 4 ₹ 382 crores

You are required to:

(1) Calculate stage of completion of contract for each year
(2) Profit to be recognised for each year.

Solution

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

Year 1: 98.8 crore / 375 crore = 26.35%
Year 2: 202.4 crore / 375 crore = 53.97%
Year 3: (310 crore – 3 crore) / (375+7) crore = 80.37%
Year 4: 382 crore / 382 crore = 100%

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

	Upto reporting date	Recognised in the prior year	Recognized in the current year
Year 1			
Revenue (400 x 26.35%)	105.40	-	105.40
Expenses	98.8	-	98.8
Profit	6.60	-	6.60
Year 2			
Revenue (400 x 53.97%)	215.88	105.40	110.48
Expenses	202.40	98.8	103.6
Profit	13.48	6.60	6.88
Year 3			
Revenue (410 x 80.37%)	329.52	215.88	113.64
Expenses	307	202.40	104.60
Profit	22.52	13.48	9.04
Year 4			
Revenue (410 x 100%)	410	329.52	80.48
Expenses	382	307	75
Profit	28	22.52	5.48

Question 3 *(RTP May 2021)* *Pg no._____*

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

Solution

According to AS 7 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii) the amount of the incentive payment can be measured reliably.

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

Question 4 *(ICAI Study Material)* *Pg no._____*

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

Solution

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

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

Question 5 *(RTP Nov 2019)/ (RTP Nov 2022)* *Pg no._____*

On 1st December, 2019, "Sampath" Construction Company Limited undertook a contract to construct a building for ₹ 108 lakhs. On 31st March, 2020 the company found that it had already spent ₹ 83.99 lakhs on the construction. A prudent estimate of additional cost for completion was ₹ 36.01 lakhs. What is the provision for foreseeable loss, which must be made in the Final Accounts for year ended 31st March, 2020 based on AS 7?

Solution

Calculation of foreseeable loss for the year ended 31st March, 2020

	₹ in Lakhs
Cost incurred till 31st March, 2020	83.99
Prudent estimate of additional cost for completion	36.01
Total cost of construction	120.00

Less: Contract price	(108.00)
Foreseeable loss	12.00

According to para 35 of AS 7 "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue; the expected loss should be recognized as an expense immediately. Therefore, amount of ₹ 12 lakhs is required to be provided for in the books of Sampath Construction Company for the year ended 31st March, 2020.

Question 6 *(RTP May 2022)* *Pg no.*_____

B Ltd. undertook a construction contract for ₹ 50 crores in April, 2019. The cost of construction was initially estimated at ₹ 35 crores. The contract is to be completed in 3 years. While executing the contract, the company estimated the cost of completion of the contract at ₹ 53 crores. Can the company provide for the expected loss in the book of account for the year ended 31st March, 2020?

Solution

As per Para 35 of AS 7 "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Therefore, The foreseeable loss of ₹ 3 crores (₹ 53 crores less ₹ 50 crores) should be recognised as an expense immediately in the year ended 31st March, 2020. The amount of loss is determined irrespective of

a) Whether or not work has commenced on the contract;
b) Stage of completion of contract activity; or
c) The amount of profits expected to arise on other contracts which are not treated as single construction contract.

Question 7 *Pg no.*_____

Five Star Construction Limited commenced a construction contract on 1st April, 2019. The Fixed Contract price agreed was ₹ 50,00,000. The company incurred ₹ 21,00,000 in 2019-20 for 40% work and received ₹ 19,00,000 as progress payment from the customer. The company estimated that a further ₹ 31,50,000 would incurred to complete it. What amount should be charged to revenue for the year 2019-20 as per AS 7?
Show the extract of Profit & Loss A/c for the year 2019- 20 in the books of the company.

Solution

	₹
Total expected loss to be provided for Contract Price –Total Cost = 50,00,000 – (21,00,000 + 31,50,000)	2,50,000
Calculation for 2019-20 on 40% work	
Contract Revenue	20,00,000
Contract Cost	21,00,000
Loss on contract	1,00,000
Expected loss recognized as per AS 7	2,50,000
Further provision required in respect of Expected Loss (₹2,50,000 - ₹1,00,000)	1,50,000

Profit & Loss A/c (Extract) for the year ended 31st March 2020

	₹		₹
To Construction costs (for 40% work)	21,00,000	By Contract Revenue	20,00,000
To Provision for loss	1,50,000	By Net Loss	2,50,000
	22,50,000		**22,50,000**

Question 8

Pg no._____

Shyan Limited commenced a construction contract on 01-04-2018. The company expended ₹500 crores in 2018-19 for 40% work. The total estimated cost of the project is ₹ 1,250 crores. Compute (i) Revenue, (ii) Expense, (iii) Provision for loss & (iv) Profit or loss to be recognized in the statement of Profit and Loss A/c as per AS-7 for the year ending 31-03-2019 if:
(1) It is fixed price contract of ₹ 1,200 crores.
(2) It is cost plus contract of 20%.

Solution

1. If it is a fixed price contract of ₹ 1,200 crores

Percentage of completion till date to total estimated cost of construction = 40%

i	Revenue (₹1,200 crores x 40%)	480
ii	Expenses	500
iii	Provision for loss (Refer Working note)	30
iv	Loss	50

2. If it is a cost-plus contract of 20%

i	Revenue (₹500 crores x 120%)	600
ii	Expenses	500
iii	Provision for loss (Refer Working note)	Nil
iv	Profit	100

Working Note: Calculation of provision for loss in case of fixed price contract

Amount of foreseeable loss	Amount (in crores)
Total cost of construction	1,250
Less: Total contract price	(1,200)
Amount of foreseeable loss	50
Loss for current year [500 – 480 (₹1,200 crores x 40%)]	(20)
Expected loss to be recognized immediately	30

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

Question 9 *(Inter May 2018) (5 Marks) / (Inter May 2023) (5 Marks) (Sim.)*

Pg no._____

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, 2020:

	₹ 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, 2020.
(ii) Contract work in progress as at end of financial year 2019-20.
(iii) Revenue to be recognized out of the total contract value.
(iv) Amount due from/to customers as at the year end.

Solution

(i) Profit/Loss for the year ended 31st March, 2020.

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, 2020 amounting ₹ 4,250 will be recognized.

(ii) Contract work in progress as at end of financial year 2019-20.

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 31.3.20 is 46.15% (7,500/16,250 x 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

Question 10 *(Inter Nov 2020) (5 Marks)* *Pg no._____*

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

Solution

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

% of work completed = $\frac{8,60,000 \times 100}{18,60,000}$ = 46.24% (rounded off)

Revenue to be recognized = 20,00,000 x 46.24% = ₹ 9,24,800

Year 2	₹
Expenditure incurred in Year 1	8,60,000
Actual expenditure in Year 2	4,75,000
Future estimated expenditure	4,00,000
	17,35,000

% of work completed = $\frac{4,75,000+ 8,60,000}{17,35,000}$ = 76.95% (rounded off)

Revenue to be recognized (cumulative)	= 20,00,000 × 76.95%	= 15,39,000
Less: Revenue recognized in Year 1		= (9,24,800)
Revenue to be recognized in Year 2		= 6,14,200

Year 3

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

Note: Calendar year has been considered as accounting year.

Question 11 *(Inter May 2022) (5 Marks)* Pg no._____

Grace Ltd., a firm of contractors provided the following information in respect of a contract for the year ended on 31st March,2022:

Particulars	(₹ in '000)
Fixed Price Contract with an escalation clause	35,000
Work Certified	17,500
Work not Certified (includes ₹ 26,25,000 for materials issued, out of which material lying unused at the end of the period is ₹ 1,40,000)	3,815
Estimated further cost to completion	17,325
Progress Payment Received	14,000
Payment to be Received	4,900
Escalation in cost is by 8% and accordingly the contract price is increased by 8%	

From the above information, you are required to:

(i) Compute the contract revenue to be recognized.

(ii) Calculate Profit /Loss for the year ended 31st March,2022 and additional provision for loss to be made, if any, for the year ended 31st March,2022.

Solution

Calculation of total estimated cost of construction

	(₹ in '000)	(₹ in '000)
Cost of Contract incurred till date		
Work certified	17,500	
Work not certified (3,815 thousand – 140 thousand)	3,675	21,175
Add: Estimated future cost		17,325
Total estimated cost of construction		**38,500**
Contract Price (35,000 thousand x 1.08)		37,800

Stage of completion

Percentage of completion till date to total estimated cost of construction

= [Cost of work completed till date / total estimated cost of the contract] x 100

= [₹ 21,175 thousand / ₹ 38,500 thousand] x 100= 55%

Revenue to be recognized for the year ended 31st March, 2022

Proportion of total contract value recognized as revenue = Contract price x percentage of completion = ₹ 37,800 thousand x 55% = ₹ 20,790 thousand

Loss to be recognized for the year ended 31st March, 2022

Loss for the year ended 31st March, 2022 = Cost incurred till date – Revenue to be recognized for the year ended 31st March, 2022

= ₹ 21,175 thousand – ₹ 20,790 thousand = ₹ 385 thousand

Provision for loss to be made at the end of 31st March, 2022

	(₹ in '000)	(₹ in '000)
Total estimated loss on the contract		
Total estimated cost of the contract	38,500	
Less: Total revised contract price	(37,800)	700
Less: Loss recognized for the year ended 31st March, 2022		(385)
Provision for loss to be made at the end of 31st March, 2022		315

Question 12 *(ICAI Study Material)* *Pg no.*_____

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

Solution

As per AS 7 'Construction Contracts', when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

a) separate proposals have been submitted for each asset;
b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
c) the costs and revenues of each asset can be identified.

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

Question 13 *(Inter May 19) (5 Marks)/(RTP May 21)/(May 23)/(Nov 23)/(ICAI SM)(ii)* *Pg no.*_____

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

(ii) On 1st December, 2019, GR Construction Co. Ltd. undertook a contract to construct a building for ₹ 45 lakhs. On 31st March, 2020, the company found that it had already spent ₹ 32.50 lakhs on the construction. Additional cost of completion is estimated at ₹ 15.10 lakhs. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2020 as per provisions of AS-7?

Solution

(i) As per AS 7 'Construction Contracts', when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:
   a) separate proposals have been submitted for each asset;
   b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
   c) the costs and revenues of each asset can be identified.

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

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

(ii)

	₹ in Lakhs
Cost of construction incurred till date	32.50
Add: Estimated future cost	15.10
Total estimated cost of construction	47.60

Percentage of completion till date = (32.50/47.60)×100 = 68.28%

Proportion of total contract value recognised as revenue = Contract price x percentage of completion = ₹ 45 Lakhs x 68.28% = ₹ 30.73 Lakhs

Amount of foreseeable loss	₹ in Lakhs
Total cost of construction	47.60
Less: Total contract price	(45.00)
Total foreseeable loss to be recognized as expense	2.60

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

Question 14 *(ICAI Study Material)* *Pg no._____*

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

Solution

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

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

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

REVENUE RECOGNITION

AS 9

Objective	AS 9 deals with the basis for recognition of revenue in the Statement of P&L. Recognition means timing of recording the revenue in the P&L A/c of enterprise.
Scope	❖ Revenue from Sale of goods. ❖ Revenue from Rendering of services ❖ Revenue from Interest, Royalties and Dividend
Non Applicability	❖ Revenue arising from Construction contracts (AS 7) ❖ Revenue arising from Hire purchase and lease agreements (AS 19) ❖ Revenue arising from Government grants and other similar subsidies (AS 12) ❖ Revenue of Insurance company arising under insurance contracts
Other examples of scope exclusions	Revenue does not include the following: ❖ Realized gains on disposal of non-current assets. Example: Gain on sale of fixed assets under AS 10. ❖ Unrealized gains on holding of Non- current assets Example: Appreciation in the value of fixed assets under AS 10. ❖ Unrealized holding gains resulting from change in value of current assets. ❖ Realized/unrealized gains resulting from changes in foreign exchange rates and adjustments arising on translation of foreign currency financial statement (AS11)
Meaning of Revenue	Revenue is the **gross inflow** of : ➢ Cash ➢ Receivables or ➢ Other consideration arising in the course of ordinary activities of an enterprise from the • Sale of goods, • Rendering of services and • Use by others of enterprise resources yielding interest; royalties and dividends. ***Exception*** – In an agency relationship, revenue is the amount of commission and not the gross inflow of cash, receivables or other considerations. ***Note***: *Trade Discounts & volume rebates to be deducted while determining revenue.*
Examples	Entity XY sells a machine being used at its factory at a price of ₹ 2 lakh. The carrying value of the machine is ₹ 1.80 lakh. The sale of the machine does not increase the revenue of XY but is an example of a capital receipt since transaction does not take place in the normal course of business. *Such gain on sale of ₹ 20,000 (₹ 2 lakhs – ₹ 1.80 lakhs) is recognised as a part of profit & loss statement under Gain/(Loss) on disposal of asset.*

	ST Ltd is a real-estate developer and builder. It is into the business of buying and selling properties. In 2022, ST Ltd purchased a unit of land for ₹ 150 crore. It sold off that land after few months at a price of ₹ 240 crore. *In the above case, the sale of land is a transaction that happens in the ordinary course of business (as he is a real estate developer and builder – properties will be an item of inventory in the financial statements) for ST Ltd. Hence, it should recognise a revenue of ₹ 240 crore when the land is sold* DL Ltd, a pharma company, has been conducting research on new medicine since last 2 years to increase the immunity levels of the people consuming it without any side effects. During the current year, it decides to sell the outcome of the research undertaken so far to another competitor, GH Ltd for ₹ 50 crore. DL has already incurred ₹30 crore on the ongoing research. *In the above example, the sale of the research findings does not represent an increase in revenue. This is because DL Ltd's business is not to sell these research findings in the ordinary course of business. The amount of ₹ 50 crore will be a part of Other Income in the profit & loss statement.* Trip Deal is a website that allows people to book airlines tickets. As a part of the business, it agrees to buys 100 tickets from an airline on a particular date and resells those tickets to customers. However, Trip Deal bears the loss for any unsold tickets. *In the above example, the risks and rewards relating to tickets are borne by Trip Deal. Hence, sales made for the tickets will be fully recognized as part of its revenue. Any unsold tickets will be charged as loss by the entity.*

CONDITIONS FOR RECOGNITION		
Sale of goods (PARA 11)	✓ The seller of goods has transferred to buyer the property in goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership. ✓ No significant uncertainty regarding consideration	
Rendering of services (PARA 12)	✓ Service is performed as per the terms of the contract i.e. either as per completed service contract method (***For Eg**: Installation of machinery or repair service*) or proportionate completion method. ✓ No significant uncertainty regarding consideration	
Use of resource of the enterprise by others (PARA 13)	**Interest**	On a <u>time proportion basis</u> taking into account the amount outstanding and the rate applicable
	Royalty	On an <u>accrual basis</u> in accordance with the terms of relevant agreement i.e. when the conditions attached have been complied with.
	Dividend	When the owners right to receive payment is established i.e. • In case of Final Dividend, date when it is declared at an AGM • In case of Interim Dividend, date it is declared in Board Meeting
	Revenue should be recognised when no significant uncertainty as to measurability or collectability exists.	

SOME IMPORTANT POINTS	
Delivery is delayed at buyer's request	When delivery is delayed at buyer's request and buyer takes title and accepts billing, revenue should be recognized when ➢ There is every expectation that delivery will be made ➢ Item must be on hand, identified & ready for delivery at time sale is recognized.
Delivery subject to installation, inspection etc.	Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. *However, in case the installation is simple (for example, a refrigerator needs to be plugged to a power connection after delivery to customer's place), revenue is recognized when the customer has agreed to purchase the goods.*
Goods on Approval basis	Revenue should not be recognized until ➢ The goods have been formally accepted by the buyer ➢ Buyer has done an act adopting the transaction ➢ Time period for rejection has lapsed
Guaranteed Sales	In the case of retail sales offering a guarantee of "money back if not completely satisfied" it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience.
Consignment	Revenue is to be recognized when goods are sold by consignee to third party
Cash on delivery	Revenue should not be recognised until cash is received by the seller or his agent
Sale to distributors or others for resale	Revenue from such sales can generally be recognized if significant risks of ownership have passed; however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.
Subscriptions for publications	Revenue should be recognised either on straight line basis over time or, where items delivered vary in value, revenue should be based on sales value of item delivered.
For Advertising agencies	Amount will be recognized when advertisement appears before the public.
Artistic Performances, banquets, etc.	Revenue from artistic performances, banquets and other special events should be recognised when the event takes place
Tuition Fees	Revenue should be recognised over the period of instruction
Insurance Agent Comm.	Revenue should be recognized on the effective commencement or renewal dates of the related policies.
Installation Fees	In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.
Instalment sales	When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognized at the date of sale. The interest element should be recognized as revenue, proportionately to the unpaid balance due to the seller.

Payment in instalments and delivery only when final payment is made	Revenue from sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received, should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.
Membership Fees	➢ If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. ➢ If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided
Price revisions	Income can be recognized when there is certainty of collection
Inter divisional Transfers	Risks and rewards remain within the enterprise and there is no consideration from the point of view of the enterprise as a whole. Hence, no revenue is recognized in the case of inter-divisional transfers.
Sale and Repurchase Agreement	For transactions, where seller concurrently agrees to repurchase the same goods at later date that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognized as revenue. **Example** On 1st January 2023, M/s KJ sells goods at invoice value of ₹ 5 lakhs to M/s TH. At the time of sale, M/s KJ has agreed to repurchase these goods back from M/s TH on 31st March at a price of ₹ 6 Lac. You are required to do the accounting for above transactions in the books of M/s KJ.

→ When the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition should be postponed to the extent of uncertainty involved. (PARA 10)

→ When the uncertainty regarding collection arises subsequent to the sale or rendering of services, then provision should be created instead of reducing the amount originally recorded.

ASSIGNMENT QUESTIONS

Question 1 – *(ICAI Study Material)*

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

Total price for the food item –	₹ 200 lakhs
Delivery charges –	₹ 60 lakhs
GST –	₹ 40 lakhs
Total –	**₹ 300 lakhs**

Zigato has received ₹ 300 lakhs for the above orders from customers and the orders were delivered to the customer in stipulated time. How much revenue should be recognised by restaurants and how much revenue should be recognised by Zigato for the year?

Solution

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

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

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

Question 2 *(RTP May 2018)*

A manufacturing company has following stages of production & sale in manufacturing Fine paper rolls:

Date	Activity	Cost to Date (₹)	Net Realisable Value (₹)
15.1.20	Raw Materials	1,00,000	80,000
20.1.20	Pulp (WIP 1)	1,20,000	1,20,000
27.1.20	Rough & Thick Paper (WIP 2)	1,50,000	1,80,000
15.2.20	Fine paper Rolls	1,80,000	3,50,000
20.2.20	Ready for Sale	1,80,000	3,50,000
15.3.20	Sale Agreed and invoice raised	2,00,000	3,50,000
02.4.20	Delivered and paid for	2,00,000	3,50,000

Explain the stage on which you think revenue will be generated and state how much would be net profit for year ending 31.3.2020 on this product according to AS-9.

Solution

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

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

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

Thus, sales will be recognized only when following two conditions are satisfied:
(i) The sale value is fixed and determinable.
(ii) Property of the goods is transferred to the customer.
Both these conditions are satisfied only on 15.3.2020 when sales are agreed upon at a price & goods are allocated for delivery purpose through invoice. The amount of net profit ₹ 150,000 (3,50,000 – 2,00,000) would be recognized in the books for the year ending 31st March, 2020.

Question 3 *(ICAI Study Material)*

During the year ended 31st March 2023, ZX Enterprises has recognized ₹ 100 lakhs on accrual basis income from dividend on units of mutual funds held by it. The dividends on mutual funds were declared on 15th June, 2023. The dividend was proposed on 10th April, 2023. Whether the above treatment is as per the relevant Accounting Standard?

Solution

Dividends from investments in shares are not recognized in the statement of profit and loss until a right to receive payment is established. In the given situation, the dividend is proposed on 10th April, 2023, while it is declared on 15th June, 2023. Thus, the right to receive the payment of dividend gets established on 15th June, 2023.
The recognition of ₹ 100 lakhs on accrual basis in the financial year 2022-2023 is not correct as per AS 9 'Revenue Recognition'.

Question 4

M/s Umang Ltd. sold goods through its agent. As per terms of sales, consideration is payable within one month. In the event of delay in payment, interest is chargeable @ 12% p.a. from the agent. The company has not realized interest from the agent in the past. For the year ended 31st March, 2020 interest due from agent (because of delay in payment) amounts to ₹ 1,72,000. The accountant of M/s Umang Ltd. booked ₹ 1,72,000 as interest income in the year ended 31st March, 2020. Discuss the contention of accountant with reference to Accounting Standard-9.

Solution

As per AS 9 "Revenue Recognition", "Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty involved. In such cases, the revenue is recognized only when it is reasonably certain that the ultimate collection will be made".
In this case, the company never realized interest for the delayed payments made by the agent. Hence, based on the past experience, the realization of interest for the delayed payments by the agent is very much uncertain. The interest should be recognized only if the ultimate collection is certain. Therefore, the interest income of ₹ 1,72,000 should not be recognized in the books for the year ended 31st March, 2020. Thus, the contention of accountant is incorrect.

Question 5 *(ICAI Study Material)*

AB sells goods to CD on 1st March 2023. CD is having significant cash flows issues since last few months. However, it is trying to raise funding through bank loan to be able to run its operations in future. On 5th of May 2023, CD is able to seek the funding and is expected to be able to pay for the goods in future. At the time of sale, it is difficult for AB to ascertain whether it will be able to collect the amount from CD due to poor financial conditions. Explain how the recognition of revenue be done by AB?

Solution

In the above case, AB should not recognise any revenue on 1st of March and until that uncertainty of recovery is clear. Hence, the revenue can only be recognised by AB on 5th of May 2023. The inventory transferred to CD until that date is required to be shown as its own inventory [inventory lying with customers].

Question 6 – *(ICAI Study Material)*

AB sells goods to CD on 1st January 2023 for ₹ 2 lakhs. After the sale was made, CD is having significant cash flows issues. It is trying to raise funding through bank loan to be able to run its operations in future. However, it is unable to do so and has gone under liquidation on 15th of March 2023. At the time of sale, there was no reason for AB to believe that it will not be able to collect the amount from CD in future.
Explain how the recognition of revenue be done by AB for the year ended 31st March 2023?

Solution

In the above case, at the time of sale, it was not unreasonable for AB to expect ultimate collection from CD. Therefore, AB should recognise the revenue of ₹ 2 lakhs on 1st of January 2023 and recognise a receivable for the same amount. Later, since CD went into liquidation, AB should write off the receivables and book a loss in his books.

Accounting in the books of AB

Question 7 *(RTP May 2020) / (ICAI Study Material)*

The following information of Meghna Ltd is provided:-

a) Goods of ₹ 60,000 were sold on 20-3-2020 but at the request of the buyer these were delivered on 10-4-2020.
b) On 15-1-2020 goods of ₹ 1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31-3-2020.
c) ₹ 1,20,000 worth of goods were sold on approval basis on 1-12-2019. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-1-2020 & no approval or disapproval received for remaining goods till 31-3-2020.
d) Apart from the above, the company has made cash sales of ₹ 7,80,000 (gross). Trade discount of 5% was allowed on the cash sales.

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

Solution

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

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

In case (a):

The sale is complete but delivery has been postponed at buyer's request. The entity should recognize the entire sale of ₹ 60,000 for the year ended 31st March, 2020.

In case (b):

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

In case (c):

In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the ₹ 90,000 upon receipt of approval on 31-01-2020 and for the balance ₹ 30,000 on 01-03 2020 as the time period for rejecting the goods had expired.

In case (d):

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

Thus total revenue amounting ₹ 10,41,000 (60,000 + 1,20,000+ 1,20,000+7,41,000) will be recognized for the year ended 31st March, 2020 in the books of Meghna Ltd.

Question 8

Victory Ltd. purchased goods on credit from Lucky Ltd. for ₹ 250 crores for export. The export order was cancelled. Victory Ltd. decided to sell the same goods in the local market with a price discount. Lucky Ltd. was requested to offer a price discount of 15%. The Chief Accountant of Lucky Ltd. wants to adjust the sales figure to the extent of the discount requested by Victory Ltd. Discuss whether this treatment is justified.

Solution

Lucky Ltd. had sold goods to Victory Ltd on credit worth for ₹ 250 crores and the sale was completed in all respects. Victory Ltd.'s decision to sell the same in the domestic market at a discount does not affect the amount recorded as sales by Lucky Ltd. The price discount of 15% offered by Lucky Ltd. after request of Victory Ltd. was not in the nature of a discount given during the ordinary course of trade because otherwise the same would have been given at the time of sale itself. It is the special discount which is being allowed at the request of the buyer. Therefore, it would be appropriate to make a separate provision rather than to adjust the amount of revenue originally recorded. Therefore, such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

Question 9

X Limited sold goods worth ₹ 13 Lakhs to Mr. Y. Mr. Y asked for a Trade Discount amounting to ₹ 1,06,000 and the same was agreed to by X Limited. Such discount was allowed in the ordinary course of business. The sale was effected and goods were dispatched. On receipt of goods, Mr. Y has found that goods worth ₹ 1,34,000 are defective. Mr. Y returned defective goods to X Limited and made payment amount to ₹ 10,60,000. The Accountant of X Limited booked the sale for ₹ 10,60,000. Discuss the contention of the Accountant with reference to relevant Accounting Standard.

Solution

As per AS 9, "Revenue Recognition" is the inflow of cash, receivable or other consideration arising in the course of ordinary activities of an enterprise from the sale of Goods. However, the above is subject to trade discount and volume rebates received in the course of carrying on business which shall be deducted in ascertaining revenue since they represent a reduction of cost.

In the given case, trade discount is to be deducted from ₹ 13,00,000 and gross sale shall be recognized at (₹ 13,00,000 - ₹ 1,06,000) = ₹ 11,94,000 and goods returned ₹ 1,34,000 are to be recorded in the form of sales return. Thus, the contention of Accountant to book sale of ₹ 10,60,000 is not correct.

Question 10

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

Solution

As per para 12 of AS 9 'Revenue Recognition', 'In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished'.

In the given case, income accrues when the related advertisement appears before public. The advertisement service would be considered as performed on the day the advertisement is seen by public and hence revenue is recognized on that date. In this case, it is 15.03.2020, the date of publication of the magazine.
Hence, ₹ 3,00,000 (₹ 2,40,000 + ₹ 60,000) is recognized as income in March, 2020. The terms of payment are not relevant for considering the date on which revenue is to be recognized. ₹ 60,000 is treated as amount due from advertisers as on 31.03.2020 and ₹ 2,40,000 will be treated as payment received against the sale.

However, if the publication is delayed till 02.04.2020 revenue recognition will also be delayed till the advertisements get published in the magazine. In that case revenue of₹ 3,00,000 will be recognized for the year ended 31.03.2021 after the magazine is published on 02.04.2020. The amount received from sale of advertising space on 10.03.2020 of ₹ 2,40,000 will be considered as an advance from advertisers for the year ended 31st March, 2020.

Question 11 *(RTP May 2019)*

Raj Ltd. entered into an agreement with Heena Ltd. to dispatch goods valuing ₹ 5,00,000 every month for next 6 months on receipt of entire payment. Heena Ltd. accordingly made the entire payment of ₹ 30,00,000 and Raj Ltd. started dispatching the goods. In fourth month, due to fire in premise of Heena Ltd., Heena Ltd. requested to Raj Ltd. not to dispatch goods worth ₹ 15,00,000 ready for dispatch. Raj Ltd. accounted ₹ 15,00,000 as sales and transferred the balance to Advance received against Sales account. Comment upon the above treatment by Raj Ltd. with reference to the provision of AS-9.

Solution

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

- the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and
- no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

In the given case, transfer of property in goods results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. Also, the sale price has been recovered by the seller. Hence, the sale is complete but delivery has been postponed at buyer's request. Raj Ltd. should recognize the entire sale of ₹ 30,00,000 (₹ 5,00,000 x 6) and no part of the same is to be treated as Advance Received against Sales.

Question 12 *(RTP Nov 2019) / (ICAI Study Material)*

The Board of Directors decided on 31.3.2020 to increase the sale price of certain items retrospectively from 1st January, 2020. In view of this price revision with effect from 1st January 2020, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2020 to 31st March, 2020. Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2019-2020. Advise.

Solution

Price revision was effected during the current accounting period 2019-2020. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2019 to 31st March, 2020. If the company is able to assess the ultimate collection with reasonable certainty, only then additional revenue arising out of the said price revision may be recognized in 2019-2020.

If the company is not reasonably certain on ultimate collection ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2019 to 31st March, 2020, it shall postpone recognition of revenue and disclose it in financial statements for year 2019-2020.

Question 13 *(ICAI Study Material)*

A claim lodged with the Railways in March, 2018 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 2020 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2020.

Solution

AS 9 on 'Revenue Recognition' states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is certain to be collected. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only ₹ 1,50,000 were collected against a claim of ₹ 2,00,000. So this transaction cannot be taken as a Prior Period Item. Hence receipt of ₹ 1,50,000 shall be recognized as revenue in year ended 31st March, 2020

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

Question 14 *(RTP Nov 2021)*

Shipra Ltd., has been successful jewelers for the past 100 years and sales are against cash only (returns are negligible). The company also diversified into apparels. A young senior executive was put in charge of Apparels business and sales increased 5 times. One of the conditions for sales is that dealers can return the unsold stocks within one month of the end of season. Sales return for the year was 25% of sales. Suggest a suitable Revenue Recognition Policy, with reference to AS 9.

Solution

As per AS 9 "Revenue recognition", revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Effect of Uncertainty- In the case of the jewelry business the company is selling for cash and returns are negligible. Hence, revenue can be recognized on sales. On the other hand, in Apparels Industry, the dealers have a right to return the unsold goods within one month of the end of the season. In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 25% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately for both Jewelry and Apparels business.

Question 15 *(RTP May 2021)*

Tonk Tanners is engaged in manufacturing of leather shoes. They provide you the following information for the year 2019-20:

a) On 31st December, 2019 shoes worth ₹ 3,20,000 were sent to Mohan Shoes for sale on consignment basis of which 25% shoes were unsold and lying with Mohan Shoes as on 31st March, 2020.

b) On 10th January, 2020, Tonk Tanners supplied shoes worth ₹ 4,50,000 to Shani Shoes and concurrently agrees to re-purchase the same goods on 11th April. 2020.

c) On 21st March, 2020 shoes worth ₹ 1,60,000 were sold to Shoe Shine but due to refurbishing of their showroom being underway, on their request, shoes were delivered on 12th April2020

You are required to advise the accountant of Tonk Tanners, when amount is to be recognised as revenue in 2019 -20 in above cases in the context of AS 9

Solution

a) Shoes sent to Mohan Shoes (consignee) for consignment sale:

In case goods are sent for consignment sale, revenue is recognized when significant risks of ownership have passed from seller to the buyer. In the given case, Mohan Shoes is the consignee i.e. an agent of Tonk Tanners and not the buyer. Therefore, the risk and reward is considered to vest with Tonk Tanners only till the time the sale is made to the third party by Mohan Shoes; although the goods are held by Mohan Shoes. Hence, in the year 2019-2020, the sale will be recognized for the amount of goods sold by Mohan Shoes to the third party i.e. for ₹ 3,20,000 x 75% = ₹ 2,40,000.

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

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue and should not be recognised as revenue in the year 2019-2020. Hence, sale of ₹ 4,50,000 to Shani Shoes should not be recognized as revenue.

c) Delivery is delayed at buyer's request

On 21st March, 2020, if Shoe Shine takes title and accepts billing for the goods then it is implied that the sale is complete and all the risk and rewards of ownership has been transferred to the buyer. In case no significant uncertainty exists regarding the amount of consideration for sale, revenue shall be recognized in the year 2019-2020 irrespective of the fact that the delivery is delayed on the request of Shoe Shine.

Question 16 *(RTP May 2022)*

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

Solution

AS 9 on Revenue Recognition, is mainly concerned with the timing of recognition of revenue in the Statement of Profit and Loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. However, when uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition. Further, as per accrual concept, revenue should be recognized as and when it is accrued i.e. recorded in the financial statements of the periods to which they relate.

In the present case, monthly rental towards license fee and variable license fee as a percentage on the turnover of the tenant (though on annual basis) is the income related to common financial year. Therefore, recognizing the fee as revenue cannot be deferred simply because the invoice is raised in subsequent period. Hence it should be recognized in the financial year of accrual. Therefore, the contention of CFO is not in accordance with AS 9.

Question 17 *(ICAI Study Material)*

For the year ended 31st March 2023, KY Enterprises has entered into following transactions.

On 31 March 2023, KY supplied two machines to its customer ST. Both machines were accepted by ST on 31 March 2023. Machine 1 was a machine that was routinely supplied by KY to many customers and the installation process was very simple.

Machine 1 was installed on 2 April 2023 by ST's employees.

Machine 2 being more specialised in nature requires an installation process which is more complicated, requiring significant assistance from KY. Machine 2 was installed between 2 and 5 April 2023. Details of costs and sales prices are as follows:

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

How should above transactions be recognized by KY Enterprises for the year ended 31st March 2023?

Solution

Machine 1: As the installation process is simple, revenue from Machine 1 will be recognized on 31 March 2023.

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

Since the question specifies that the machine is already accepted by ST on 31 March 2023, the revenue arising from sale of the machine needs to be recognized for the year ending 31 March 2023. This is because acceptance of the machine indicates that the risks and rewards pursuant to the ownership are transferred to ST.

Machine 2: Installation process for Machine 2 is more complicated, requiring significant assistance from KY Ltd. However, question specifies that the machine is already accepted by ST on 31 March 2023. Assuming that there is no further approval/acceptance required from the buyer for the Machine sold, revenue from sale of Machine 2 can be recognized for the year ending 31 March 2023.

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

However, installation fee which is for rendering installation services cannot be recognized until the installation is complete. Since the machine is pending installation, the revenue in respect of installation charges ₹10,000 needs to be recognized on 5 April 2023 once the installation process gets completed.

PRACTICE QUESTIONS

Question 1 *(ICAI Study Material)*

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2019-20. You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution

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

a) Interest: on time proportion basis taking into account amount outstanding & rate applicable. Therefore X Ltd. should recognise interest revenue of ₹ 10 lakhs.

b) Royalties: on an accrual basis in accordance with the terms of the relevant agreement. Therefore X Ltd. should recognise royalty revenue of ₹ 15 lakhs.

Question 2 *(Inter May 2019) (5 Marks) / (RTP Nov 2023)/ (Nov 2018)/ (Nov 2020) (Sim.)*

Given below are the following information of B.S. Ltd.

(i) Goods of ₹ 50,000 were sold on 18-03-2020 but at the request of the buyer these were delivered on 15-04-2020.

(ii) On 13-01-2020 goods of ₹ 1,25,000 are sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31-03-2020.

(iii) ₹ 1,00,000 worth of goods were sold on approval basis on 01-12-2019. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-01-2020 and no approval or disapproval received for the remaining goods till 31-03-2020.

You are required to advise accountant of B.S. Ltd., with valid reasons, amount to be recognized as revenue for the year ended 31st March, 2020 in above cases in the context of AS-9

Solution

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

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

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

Case (i)

The sale is complete but delivery has been postponed at buyer's request. B.S. Ltd. should recognize the entire sale of ₹ 50,000 for the year ended 31st March, 2020.

Case (ii)

In case of consignment sale revenue should not be recognized until the goods are sold to a third party. 20% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for ₹ 1,00,000 (80% of ₹ 1,25,000).

Case (iii)

In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting ₹ 1,00,000 as the time period for rejecting the goods had expired.

Thus total revenue amounting ₹ 2,50,000 (50,000 + 1,00,000+ 1,00,000) will be recognized for the year ended 31st March, 2020 in the books of B.S. Ltd.

Question 3

In the year 2020-21, XYZ supplied goods on Consignment basis to ABC – a retail outlet worth ₹ 10,00,000. As per the terms, ABC will only pay XYZ for the goods which are sold by them to the third party. Rest of the goods can be returned back to XYZ and ABC will not have any further liability for these goods. During the year 2020-21, ABC has sold goods worth ₹ 5,50,000 only and rest of the goods are still lying in its store which may get sold by next year. Advise XYZ, how much revenue it can recognize in its books for period 2020-21

Solution

As per AS 9, For consignment risk and rewards are not transferred to the customer on just delivery of the goods and no revenue should be recognized until the goods are sold to a third party. Therefore, XYZ can recognize revenue of ₹ 5,50,000 only.

Question 4

Khetan Ltd. has received two lakh subscriptions during the current year under its new scheme whereby customers are required to pay a sum of ₹ 4,500 for which they will be entitled to receive a magazine for a period of 3 years. Khetan wants to treat the entire amount as revenue for the current year. Comment

Solution

As per AS 9 'Revenue Recognition', revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

Accordingly, in the given case the accounting treating adopted by Khetan Ltd. to treat the entire amount as revenue for the current year is not in accordance with AS 9. The revenue should be recognized on a straight line basis over the period of 3 years.

Question 5 *(Inter Nov 2019) (5 Marks)/ (RTP May 2022)*

Indicate in each case whether revenue can be recognized and when it will be recognized as per AS-9.

(1) Trade discount and volume rebate received.
(2) Where goods are sold to distributors or others for resale.
(3) Where seller concurrently agrees to repurchase the same goods at a later date.
(4) Insurance agency commission for rendering services.
(5) On 11-03-2019 cloths worth ₹ 50,000 were sold to X mart, but due to refurbishing of their showroom being underway, on their request, clothes were delivered on 12-04-2019.

Solution

(1) Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.
(2) When goods are sold to distributor or others, revenue from such sales can generally be recognized if significant risks of ownership have passed; however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.
(3) For transactions, where seller concurrently agrees to repurchase the same goods at a later date that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognized as revenue.
(4) Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

(5) On 11.03.2019, if X mart takes title and accepts billing for the goods then it is implied that the sale is complete and all risk and reward on ownership has been transferred to the buyers. Revenue should be recognized for year ended 31st March, 2019 notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made and items were ready for delivery to the buyer at the time.

Question 6 *(Inter Dec 2021) (5 Marks)*

Given the following information of Rainbow Ltd.

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

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

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

(iv) Dew Ltd, used certain assets of Rainbow Ltd. Rainbow Ltd. received ₹ 7.5 lakhs and ₹ 12 as interest and royalties respectively from Dew Ltd. during the year 2020-21.

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

In each of the above cases, you are required to advise, with valid reasons, the amount to be recognized as revenue under the provisions of AS-9.

Solution

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

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

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

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

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

Question 7 *(RTP Nov 2022)*

When revenue will be recognized in the following situation:

(1) Where the purchaser makes a series of installment payments to the seller and the seller deliver the goods only when the final payment is received.

(2) Where seller concurrently agrees to repurchase the same goods at a later date.

(3) Where goods are sold to distributors, dealers or others for resale.

(4) Commissions on service rendered as agent on insurance business

Solution

(1) Revenue from sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received, should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

(2) For sale where seller concurrently agrees to repurchase the same goods at a later date, such transactions are in substance a financing agreement. In such a situation, the resulting cash inflow should not be recognised as revenue.

(3) Revenue from sales of goods to distributors, dealers or others for resale can generally be recognised if significant risks of ownership have passed. However, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

(4) Commissions on service rendered as agent on insurance business should be recognised as revenue when the service is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

Question 8

XY Ltd sells goods worth ₹ 50 lakh on 20 February 2023 to AB Ltd. AB Ltd is facing storage capacity constraints at their warehouse. AB Ltd instructs XY Ltd to hold the goods at XY Ltd's warehouse and arrange for delivery on 15 March 2023. However, all the risks and rewards associated with the sold goods are deemed transferred to AB Ltd. When XY Ltd. can recognise the revenue?

Solution

In the current scenario, delivery of goods sold is delayed at the request of buyer. XY Ltd can recognize revenue for sale of goods to AB Ltd on 20 February 2023 provided that goods sold to AB Ltd are held in XY Ltd's warehouse separately and are not clubbed with other inventory.

Question 9 *(ICAI Study Material)*

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

When should Entity GH recognize revenue in its books?

Solution

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

Question 10 *(Inter Nov 2022) (5 Marks)*

Indicate whether revenue can be recognized and when it will be recognized as per AS-9.

a) Delivery is delayed at buyer's request but buyer takes title and accepts billing.
b) Instalment Sales.
c) Trade discounts and volume rebates.
d) Insurance agency commission for rendering services.
e) Advertising commission.

Solution

a) **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.

b) **Instalment sales**: When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognized at the date of sale. The interest element should be recognized as revenue, proportionately to the unpaid balance due to the seller.

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

d) **Insurance agency commissions for rendering services**: Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

e) **Advertising commission**: Revenue should be recognized when the service is completed. For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognized when the project is completed.

Question 11 *(Inter May 2023) (5 Marks)* *Pg no._____*

Toy Ltd. is engaged in manufacturing toys. They provide you the following information as on 31st March, 2023:

a. On 15th January, 2023, Toys worth ₹ 5,00,000 were sent to A Ltd. on consignment basis of which 25% Toys unsold were lying with A Ltd. as on 31st March, 2023.

b. Toys worth ₹ 2,25,000 were sold to S Ltd. on 25th March, 2023 but at the request of S Ltd., these were delivered on 15th April, 2023.

c. On 1st November, 2022, toys worth ₹ 3,50,000 were sold on approval basis. The period of approval was 4 months after which they were considered sold. Buyer sent approval for 75% goods upto 31st December, 2022 and no approval or disapproval received for the remaining goods till 31st March, 2023.

You are required to advise the accountant of Toy Ltd., the amount to be recognised as revenue in above cases in the context of AS-9.

Solution

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

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

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

Case (i) 25% toys lying unsold with consignee should be treated as closing inventory and sales should not be recognized for ₹ 1,25,000 (25% of ₹ 5,00,000). In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

Sales for ₹ 3,75,000 (75% of ₹ 5,00,000) should be recognized for the year ended 31st March, 2023.

Case (ii) The sale is complete but delivery has been postponed at buyer's request. The entity should recognize the entire sale of ₹ 2,25,000 for the year ended 31st March, 2023.
Case (iii) In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting ₹ 3,50,000 as the time period for rejecting the goods had expired.

Question 12 *(ICAI Study Material)*

PQR Ltd., sells agriculture products to dealers. One of the conditions of sale is that interest is at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2023-24 the company wants to recognize the entire interest receivable. Do you agree?

Solution

As per AS 9 'Revenue Recognition', where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.
Thus, PQR Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstanding is also an estimate based on previous record and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

Question 13 *(RTP May 2024)*

Following information of BS Products Ltd. is given:
(i) Goods of ₹ 2,00,000 sold to Den Ltd. on 20-03-2023 but at the request of the buyer these were delivered on 10-04-2023. ·
(ii) On 15-01-2023 goods of ₹ 3,00,000 were sent on consignment basis, of which 20% of the goods unsold are lying with the consignee as on 31-03-2023.
(iii) ₹ 4,00,000 worth of goods were sold on approval basis on 01-12-2022. The period of approval was 3 months after which they were considered as sold. Buyer sent approval for 75% goods upto 31-01-2023 and no approval or disapproval received for the remaining goods till 31-03-2023.
(iv) Apart from the above, BS Products Ltd. sells goods to dealers also. One of the conditions of sale is that interest is payable @ 2% p.m. for delayed payments by dealers. The percentage of interest recovery is only 10% i.e. ₹ 50,000 on such overdue outstanding due to various reasons. During the year 2022-23, the company wants to recognize the entire interest receivable of ₹ 60,000.

You are required to advise the accountant of BS Products Ltd., with valid reasons, the amount to be recognized as revenue in above cases in the context of AS 9 and also determine the total revenue to be recognized for the year ending 31-03-2023.

Solution

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

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

Case (i)
The sale is complete, but delivery has been postponed at buyer's request. BS Products Ltd. Should recognize the entire sale of ₹ 2,00,000 for the year ended 31st March, 2023.

Case (ii)
20% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for ₹2,40,000 (80% of ₹ 3,00,000). In the case of consignment sale revenue should not be recognized until the goods are sold to a third party.

Case (iii)
In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting to ₹ 4,00,000 as the time period for rejecting the goods had expired.

Case (iv)
As per the standard, "where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty involved. In such cases, the revenue is recognized only when it is reasonably certain that the ultimate collection will be made". In this case, interest should be recognized only if the ultimate collection is certain and the company expects to realize interest for the delayed payments for ₹ 50,000 only. Hence, based on the past experience, the realization of interest for the delayed payments by the agent is certain only to the extent of this amount and not ₹ 60,000. Therefore, interest income of ₹ 50,000 should be recognized in the books for the year ended 31st March, 2023.
Thus, total revenue amounting ₹ 8,90,000 (2,00,000 + 2,40,000 + 4,00,000 + 50,000) will be recognized for the year ended 31st March, 2023 in the books of BS Products Ltd.

Question 14 *(RTP Sep 2024)*

When will the revenue be recognized in the case of inter divisional transfers?

Solution
The Accounting Standard Board of lCAl has come up with an announcement in the earlier years wherein it clarified that the inter- divisional transfers/sales are not revenue as per AS 9 "Revenue Recognition". According to it, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Therefore, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers. Hence, no revenue is recognized in the case of inter-divisional transfers.

Question 15 *(RTP Jan 2025)*

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

Solution

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

Journal Entries in the books of Mithya Ltd.

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

* The balance of Satya Ltd.'s account will be disclosed as an advance under the heading liabilities in the balance sheet of Mithya Ltd. as on 31st March, 2024.

PROPERTY, PLANT & EQUIPMENT

AS 10

Meaning	Property, plant and equipment (PPE) are **tangible items** that: a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and b) are expected to be used during more than a period of 12 months. Example: Building, Plant & Machinery, Furniture, etc.
"Administrative purposes": The term 'Administrative purposes' has been used in **wider sense** to **include all business purposes. Thus, PPE would include assets used for:** ▪ Selling & distribution ▪ Finance & accounting ▪ Personnel & other functions of Enterprise	
Items of PPE may also be acquired for **safety or environmental reasons.** The acquisition of such PPE, although not directly increasing the future economic benefits of any particular existing item of PPE, may be necessary for an enterprise to obtain the future economic benefits from its other assets. **Example:** A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals	
Non Applicability	❖ biological assets (***other than bearer plants***) related to agricultural activity. This AS applies to bearer plants but it does not apply to the produce on bearer plants; and ❖ wasting assets including mineral rights, expenditure on exploration for & extraction of minerals, oil, natural gas and similar non-regenerative resources. *AS 10 applies to PPE used **to develop or maintain** the assets described above*
OTHER DEFINITIONS	
Biological Asset	It is a living animal or plant.
Bearer Plant	is a plant that a) is used in the production or supply of agricultural produce; b) is expected to bear produce for more than a period of 12 months; and c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.
The following are not Bearer Plants: **(a)** Plants cultivated to be ***harvested*** *as* Agricultural produce **Example:** Trees grown for use as lumber **(b)** Plants cultivated **to produce** Agricultural produce when there is more than a remote likelihood that the entity will **also harvest and sell** the plant as agricultural produce, other than as incidental scrap sales **Example:** Trees which are cultivated both for their fruit and their lumber **(c)** Annual crops **Example:** Maize and wheat **Note:** When bearer plants are no longer used to bear produce they might be cut down and sold as scrap. For example - use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a Bearer Plant.	

RECOGNITION CRITERIA FOR PPE

The **cost of an item of PPE** should be recognised as an asset **if, and only if:**

a) It is probable that **future economic benefits** associated with the item will flow to the enterprise, and

b) The **cost** of the item can be **measured reliably**

Notes:

- It may be **appropriate to aggregate individually insignificant items**, such as moulds, tools and dies and to apply the criteria to the aggregate value.
- An enterprise **may decide to expense an item** which could otherwise have been included as PPE, because the amount of the expenditure is not material.

TREATMENT OF SPARE PARTS, STAND BY EQUIPMENT & SERVICING EQUIPMENT

Case I	**If they meet the definition of PPE as per AS 10:** ▪ Recognised as PPE as per AS 10
Case II	**If they do not meet the definition of PPE as per AS 10:** ▪ Such items are classified as Inventory as per AS 2

TREATMENT OF SUBSEQUENT COSTS

COST OF DAY-TO-DAY SERVICING

Meaning	These 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 the item of PPE.
Accounting Treatment	Recognised in the Statement of Profit and Loss as incurred.

REPLACEMENT OF PARTS OF PPE

Meaning	Parts of some items of PPE may require replacement at regular intervals. **Examples:** o Seats or Engine in Aircraft o Turbine in Machine
Accounting Treatment	Cost of new part is recognized (added) and Carrying Amount of old part is derecognized. **New Carrying Amount** Carrying Amount of PPE on date of replacement + Cost of new part – Carrying Amount of old part on date of Replacement **Note:** If carrying Amount of old Part is not given then: 1) Start with cost of New Part & compute its Present Value to the date of recognition of old Part: It is considered as cost of old Part 2) Deduct Depreciation on above amount upto the date of Part replacement to get carrying Amount of old Part on date of Replacement.

REGULAR MAJOR INSPECTIONS

Accounting Treatment	Same treatment as of Replacement of Parts

MEASUREMENT OF PPE (At Recognition: Cost Model)

Cash / Direct purchase

Cost of PPE includes the following:

Purchase price (Net of Trade discount & rebates)	XX
Add: Taxes & Duties (Non-refundable)	XX
Add: Costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management*	XX
Add: Estimated Decommissioning, Restoration costs etc. (Consider at **Present value** if given or can be calculated)	XX
Cost of PPE	**XX**

*** Examples of directly attributable costs are:**

- Costs of employee benefits (as defined in AS 15) arising directly from construction or acquisition of the item of PPE
- Costs of site preparation
- Initial delivery and handling costs
- Installation and assembly costs
- Costs of testing whether the asset is functioning properly, after deducting net proceeds from selling any items produced while bringing asset to that location & condition (such as samples produced when testing equipment)
- Professional fees

Costs that are not included in carrying item of PPE: (EXCLUSIONS)

- Costs of opening a new facility or business, such as, inauguration costs;
- Costs of introducing a new product or service (including costs of advertising and promotional activities);
- Costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- Administration and other general overhead costs
- Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.
- Initial operating losses, such as those incurred while demand for the output of an item builds up. and
- Costs of relocating or reorganizing part or all of the operations of an enterprise.

Example: Income may be earned through using a building site as a car park until construction starts because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in the Statement of Profit & Loss and included in their respective classifications of income & expense.

Self constructed assets

- Any **internal profits are eliminated** **in arriving at such costs.**
- Cost of **abnormal amounts** of wasted material, labour, or other resources is **not included** in the cost of asset.
- Borrowing Costs (interest costs) to be added to the cost of a self-constructed item of PPE as per AS 16.

MEASUREMENT OF COST
(Cost of an item of PPE is the cash price equivalent at the recognition date)

In Exchange for Non-monetary Asset	Cost of such an item of PPE is **measured at fair value unless:** a) Exchange transaction lacks commercial substance; **Or** b) Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable. **Note:** • If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.
Purchase for Consolidated Price	Where several items of PPE are purchased for a consolidated price, the consideration is **apportioned** to the various items on the **basis of their respective fair values** at the date of acquisition.
Deferred Consideration	Total payment – Cash price equivalent ▪ Is recognised as **Interest** over the period of credit ▪ unless such interest is capitalised in accordance with AS 16

MEASUREMENT AFTER RECOGNITION

An enterprise should choose **Either** Cost model **Or** Revaluation model as its accounting policy and should apply that policy to an **entire class of PPE.**
If an item of PPE is revalued, the entire class of PPE to which that asset belongs should be revalued.
Class of PPE: A class of PPE is a grouping of assets of a **similar nature and use** in operations of an enterprise.
Examples of separate classes:
(a) Land (b) Land and Buildings (c) Machinery (d) Ships (e) Aircraft (f) Motor Vehicles (g) Furniture and Fixtures (h) Office Equipment (i) Bearer plants

Cost Model	After recognition as an asset, an item of PPE should be carried at: Cost – Any Accumulated Depreciation – Any Accumulated Impairment losses
Revaluation Model	After recognition as an asset, an item of PPE whose fair value can be measured reliably should be carried at a revalued amount.

Fair value at the date of the revaluation	XX
Less: Any subsequent accumulated depreciation	(XX)
Less: Any subsequent accumulated impairment losses	(XX)
Carrying value	**XX**

Frequency of Revaluations	**A. Items of PPE experience significant and volatile changes in Fair value** Annual revaluation shall be done. **B. Items of PPE with only insignificant changes in Fair value** Revaluation shall be done at an interval of 3 or 5 years

REVALUATION: INCREASE OR DECREASE

First Revaluation	**Upward**	Use Revaluation Surplus (R/S)
	Downward	Use P&L A/c

Subsequent Revaluation

Case	1st	2nd	1st	2nd
1	↑	↑	R/S	R/S
2	↓	↓	P & L	P&L
3	↑	↓	R/S	Use R/S 1st then P&L
4	↓	↑	P & L	Use P&L 1st then R/S

Treatment of Revaluation Surplus	The revaluation surplus **may be transferred to Revenue Reserves when the asset is derecognised.** **Case I: When whole surplus is transferred:** When the asset is: ▪ Retired Or ▪ Disposed of **Case II: Some of the surplus may be transferred as asset is used by an enterprise:** In such a case, the amount of the surplus transferred would be: Dep. (based on Revalued Carrying amount) – Dep. (based on Original Cost) Transfers from Revaluation Surplus to the Revenue Reserves are **not made** through the Statement of Profit and Loss	
ACCOUNTING TREATMENT OF REVALUATION		
Technique 1	Proportionate Increase/Decrease in Gross Carrying Amount & Accumulated Depreciation **Steps:** 1) Find Revaluation Gain/Loss (%) $\frac{\text{Revaluation Gain/Loss}}{Carrying\ Amount} \times 100$ 2) Increase Gross Block & Acc. Dep. by (%) 3) PPE A/c-Dr To Accumulated Depreciation A/c To Revaluation Gain A/c	
Technique 2	Accumulated depreciation is eliminated 1) Accumulated Depreciation A/c-Dr To PPE A/c 2) PPE A/c -Dr To Revaluation Gain A/c	
DEPRECIATION		
Component Method of Depreciation	Each part of an item of PPE with a **cost that is significant in relation to the total cost** of the item should be **depreciated separately**. **Example:** It may be appropriate to depreciate separately the airframe and engines of an aircraft	
Depreciable Amount	**Depreciable amount is:** Cost of asset or other amount substituted for cost i.e. Revalued amount - Residual value The depreciable amount of an asset should be **allocated on a systematic basis** over its useful life	
Useful Life	***Based on period***	The period over which a depreciable asset is expected to be used by the enterprise
	Based on units	The number of production or similar units expected to be obtained from the use of the asset by the enterprise
	Notes	• Useful life means economic life of the asset and is generally shorter than its physical life. • It is estimated after considering the following factors: ✓ Expected physical wear and tear. ✓ Pre-determined by legal or contractual limits such as expiry dates of related leases. ✓ Obsolescence such as technological changes, improvement in production method etc. ✓ No of shifts in which the asset is to be used.

Review of Residual Value and Useful Life	Residual value and the useful life of an asset should be reviewed **at least at each financial year-end** and, if expectations differ from previous estimates, the change(s) should be accounted for as a **change in an accounting estimate**. ***(Prospective Effect)***
Commence	Depreciation of an asset begins when it is **available for use**
Cessation of Depreciation	**I. When asset's residual value exceeds it's carrying amount** **II. Earlier of:** ▪ The date that the asset is retired from active use & is held for disposal, and ▪ The date that the asset is derecognised Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated. However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

LAND AND BUILDINGS

Land & buildings are separable assets & accounted separately, even when they are acquired together

A. Land	Land has an unlimited useful life and therefore is not depreciated. **Exception: Where land has limited useful life**
B. Buildings	Buildings have a limited useful life and therefore are depreciable assets.

DEPRECIATION METHOD

The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise.

Straight-line Method	Results in a constant charge over the useful life. Straight Line Depreciation = (Cost **Less** Residual Value) / Useful Life
Diminishing Balance Method	Results in a decreasing charge over the useful life. Depreciation Amount for each year is computed by applying a fixed % on the Opening Balance of the Asset (i.e. Diminishing Balance of the Asset.)
Units of Production Method	Results in a charge based on the expected use or output

REVIEW OF DEPRECIATION METHOD

If there has been a significant change in the expected pattern of consumption of the future economic benefits, the method should be changed to reflect the changed pattern.
Such a change should be accounted for as a **change in an accounting estimate**.
Depreciation Method based on Revenue: Not appropriate

CHANGES IN EXISTING DECOMMISSIONING, RESTORATION & OTHER LIABILITIES

Cost of PPE may undergo changes subsequent to its acquisition/construction on account of:
▪ Changes in Liabilities
▪ Price Adjustments
▪ Changes in Duties
▪ Changes in initial estimates of amounts provided for Dismantling, Removing, Restoration &
▪ Similar factors
The above are included in the cost of the asset.

RETIREMENT	
Meaning	Asset is retired from active use & held for disposal
Treatment	❖ Recorded in the books at Carrying Amount or NRV, whichever is lower. ❖ Any expected loss is recognized immediately in the P&L statement.
DE-RECOGNITION	
When	**The carrying amount of an item of PPE should be derecognised:** ▪ On disposal o By sale o By entering into a finance lease, or o By donation, or ▪ When no future economic benefits are expected from its use or disposal
Treatment	The gain or loss arising from derecognition should be included in the statement of profit and loss
DISCLOSURES	
General Disclosures	**The financial statements should disclose, for each class of PPE:** ❖ The measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount; ❖ The depreciation methods used; ❖ The useful lives or the depreciation rates used. In case useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact; ❖ The gross carrying amount & accumulated depreciation (aggregated with accumulated impairment losses) at the beginning & end of the period; and ❖ A reconciliation of the carrying amount at the beginning & end of the period
Additional Disclosures	The financial statements should also disclose: ❖ The existence and amounts of restrictions on title, and property, plant & equipment pledged as security for liabilities; ❖ The amount of expenditure recognised in carrying amount of an item of property, plant and equipment in the course of its construction; ❖ The amount of contractual commitments for the acquisition of property, plant and equipment; ❖ If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant & equipment that were impaired, lost or given up that is included in the statement of P&L; and ❖ The amount of assets retired from active use and held for disposal.
Disclosures related to Revalued Assets	If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed: ❖ The effective date of the revaluation; ❖ Whether an independent valuer was involved; ❖ Methods & significant assumptions applied in estimating fair values of item ❖ The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and ❖ The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

ASSIGNMENT QUESTIONS

Question 1 *(RTP May 2018) / (ICAI Study Material)* *Pg no.*_____

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

Solution

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

Question 2 *(ICAI Study Material)* *Pg no.*_____

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

a) Setup costs of ₹ 5,00,000 to install machinery in the new location.

b) Rent of ₹ 15,00,000

c) Removal costs of ₹3,00,000 to transport machinery from old location to temporary location.

Can these costs be capitalised into the cost of the new building?

Solution

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

Question 3 *(ICAI Study Material)* *Pg no.*_____

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

Solution

As per provisions of AS 10, any cost directly attributable to bring the assets to location and condition necessary for it to be capable of operating in the manner indicated by management are called directly attributable costs and would be included in the costs of an item of PPE.

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

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

Question 4 *(ICAI Study Material)* *Pg no.*_____

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

Solution

The net operating costs should not be capitalised, but should be recognised in the Statement of Profit and Loss. Even though it is running at less than full operating capacity (in this case 80% of operating capacity), there is sufficient evidence that the amusement park is capable of operating in the manner intended by management. Therefore, these costs are specific to the start-up and, therefore, should be expensed as incurred.

Question 5 *(ICAI Study Material) (Similar)* *Pg no.*_____

With reference to AS-10 Revised, classify the items under the following heads:

HEADS

(i) Purchase Price of Property, Plant and Equipment (PPE)
(ii) Directly attributable cost of PPE or
(iii) Cost not included in determining the carrying amount of an item of PPE.

ITEMS

(1) Import duties and non-refundable purchase taxes.
(2) Initial delivery and handling costs.
(3) Costs of testing whether asset is functioning properly, after deducting the net proceeds
(4) Initial operating losses, such as those incurred while demand for the output of an item builds up.
(5) Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.
(6) Trade discounts and rebates.
(7) Costs of relocating or reorganizing part or all of the operations of an enterprise.
(8) Installation and assembly costs.
(9) Cost of site preparation
(10) Administration and other general overhead costs.

Solution

ITEMS	HEADS	ITEMS	HEADS

*Considered that this cost of testing is after deducting net proceeds from selling any items produced while bringing asset to that location & condition otherwise if net proceeds are after fixing the asset to its location and condition (asset ready for use), it will be classified under category (iii) i.e. Cost not included in determining the carrying amount of an item of PPE.

Question 6 *(RTP May 2021)* *Pg no.*_____

You are required to give correct accounting treatment for the following in line with provisions of AS 10:

ABC Ltd is setting up a new refinery outside the city limits. In order to facilitate the construction of the refinery and its operations, ABC Ltd. is required to incur expenditure on the construction/ development of railway siding, road and bridge. Though ABC Ltd. incurs the expenditure on the construction/development, it will not have ownership rights on these items and they are also available for use to other entities and public at large. Can ABC Ltd. capitalize expenditure incurred on these items as property, plant and equipment (PPE)?

Solution

AS 10 states that the cost of an item of property, plant and equipment shall be recognized as an asset if, and only if:

(a) it is probable that future economic benefits associated with item will flow to the entity; &

(b) the cost of the item can be measured reliably.

Further, the standard provides that the standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. The cost of an item of property, plant and equipment comprise any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, railway siding, road and bridge are required to facilitate the construction of the refinery and for its operations. Expenditure on these items is required to be incurred in order to get future economic benefits from the project as a whole which can be considered as the unit of measure for the purpose of capitalization of the said expenditure even though the company cannot restrict the access of others for using the assets individually.

It is apparent that the aforesaid expenditure is directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

In view of this, even though ABC Ltd. may not be able to recognize expenditure incurred on these assets as an individual item of property, plant and equipment in many cases (where it cannot restrict others from using the asset), expenditure incurred may be capitalized as a part of overall cost of the project.

From this, it can be concluded that, in the given case the expenditure incurred on these assets, i.e., railway siding, road and bridge, should be considered as the cost of constructing the refinery and accordingly, expenditure incurred on these items should be allocated and capitalized as part of the items of property, plant and equipment of the refinery.

Question 7 *(RTP May 2019) (Similar) / (RTP Nov 2023) / (ICAI Study Material)* *Pg no.*_____

ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

Cost of the plant (cost per supplier's invoice plus taxes)	25,00,000
Initial delivery and handling costs	2,00,000
Cost of site preparation	6,00,000
Consultants used for advice on the acquisition of the plant	7,00,000
Interest charges paid to supplier of plant for deferred credit	2,00,000
Estimated dismantling costs to be incurred after 7 years	3,00,000
Operating losses before commercial production	4,00,000

Please advise ABC Ltd. on the costs that can be capitalized in accordance with AS 10 (Revised).

Solution

According to AS 10 (Revised), these costs can be capitalized

Cost of the plant (cost per supplier's invoice plus taxes)	25,00,000
Initial delivery and handling costs	2,00,000
Cost of site preparation	6,00,000
Consultant's fees	7,00,000
Estimated dismantling costs to be incurred after 7 years	3,00,000
	43,00,000

Note: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of ₹ 2,00,000 and operating losses before commercial production amounting to ₹ 4,00,000 are not regarded as directly attributable costs and thus cannot be capitalized. They should be written off to the Statement of Profit and Loss in the period they are incurred.

Question 8 *(RTP May 2023) / (ICAI Study Material)* *Pg no._____*

Star Limited purchased machinery for 6,80,000 (inclusive of GST of 40,000). Input credit is available for entire amount of the GST paid.

The company incurred the following other expenses for installation.

	₹
Cost of preparation of site for installation	21,200
Total labour charges (200 out of total of 500 men hours worked, were spent for installation of the machinery)	56,000
Spare parts and tools consumed in installation	5,000
Total salary of supervisor (time spent for installation was 25% of the total time worked.)	26,000
Total technical expenses (1/10 relates to the plant installation)	34,000
Test run & experimental production charges	18,000
Consultancy charges to architect for plant set up	11,000
Depreciation on assets used for the installation	12,000

The machine was ready for use on 15-1-2022 but was used from 1-2-2022. Due to this delay further expenses of ₹ 8,900 were incurred.

Calculate the value at which the plant should be capitalized in the books of Star Limited.

Question 9 – *(RTP Nov 2019) / (RTP Nov 2020) (Similar)* *Pg no._____*

Shrishti Ltd. contracted with a supplier to purchase machinery which is to be installed in its Department A in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were ₹ 1,41,870. These activities were supervised by a technician during the entire period, who is employed for this purpose of ₹ 45,000 per month. The technician's services were given by Department B to Department A, which billed the services at ₹ 49,500 per month after adding 10% profit margin. The machine was purchased at ₹ 1,58,34,000 inclusive of IGST @ 12% for which input credit is available to Shrishti Ltd. ₹ 55,770 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of ₹ 30,000 to supervise machinery installation at the factory site.

Ascertain the amount at which the Machinery should be capitalized under AS 10 considering that IGST credit is availed by the Shrishti Limited. Internally booked profits should be eliminated in arriving at the cost of machine.

Question 10 *(ICAI Study Material)* *Pg no.*_____

Preet Ltd. intends to set up a steel plant, for which it has acquired a dilapidated factor having an area of 5,000 acres at a cost of ₹ 60,000 per acre. Preet Ltd. has incurred ₹ 1.10 crores on demolishing the old Factory Building thereon. A sum of ₹ 63,00,000 (including 5% GST thereon) was realized from the sale of material salvaged from the site. Preet Ltd. incurred Stamp Duty and Registration Charges of 7% of land value, paid legal and consultancy charges ₹ 8,00,000 for land acquisition and incurred ₹ 1,25,000 on title guarantee insurance.
Compute the value of the land acquired.

Solution

Particulars	₹ (in Lakhs)
Purchase Price: 5,000 acres x ₹ 60,000 per acre	3,000.00
Stamp Duty and Registration Charges at 7%	210.00
Legal and Consultancy Fees	8.00
Title Guarantee Insurance	1.25
Demolition Expenses (Net of Salvage Income) [₹ 110 lakhs (–)₹ 60 lakhs (₹ 63 lakhs x 100/105)]	50.00
Cost of Land	**3,269.25**

Question 11 *(ICAI Study Material)* *Pg no.*_____

Entity A exchanges land with a book value of ₹ 10,00,000 for cash of ₹ 20,00,000 and plant and machinery valued at ₹ 25,00,000. What will be the measurement cost of the assets received? (Consider that transaction has commercial substance)

Solution

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

ENTRY:

Question 12 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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

ENTRY:

Question 13 - *(ICAI Study Material)* *Pg no._____*

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

Solution

Entity A's management can apply the revaluation model only to the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location. AS 10 permits assets to be revalued on a class by class basis. The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement.

However, all properties within the class of office buildings must be carried at revalued amount.

Question 14 *Pg no._____*

A Ltd. has an item of plant with an initial cost of ₹ 1,00,000. At the date of revaluation, accumulated depreciation amounted to ₹ 55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.

Pass Journal Entries with regard to Revaluation?

Question 15 *(RTP May 2020) / (ICAI Study Material)* *Pg no._____*

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

Solution

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

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

Question 16 *(RTP May 2018)* *Pg no._____*

In the year 2021-22, an entity has acquired a new freehold building with a useful life of 50 years for ₹ 90,00,000. The entity desires to calculate the depreciation charge per annum using a straight-line method. It has identified the following components (with no residual value of lifts & fixtures at the end of their useful life) as follows:

Component	Useful life (Years)	Cost
Land	Infinite	20,00,000
Roof	25	10,00,000
Lifts	20	5,00,000
Fixtures	10	5,00,000
Remainder of building	50	50,00,000
		90,00,000

Calculate depreciation for the year 2021-22 as per componentization method

Question 17 *(ICAI Study Material)* *Pg no.*_____

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

Solution

Management should determine the depreciation method based on production output. The straight-line depreciation method should be adopted, because the production output is consistent from year to year.

Factors such as maintenance costs or technical obsolescence should be considered in determining the blending machines' useful life.

Question 18 *Pg no.*_____

A machinery with a useful life of 6 years was purchased on 1st April, 2019 for ₹ 1,50,000. Depreciation was provided on straight line method for first three years considering a residual value of 10% of cost.

In the beginning of fourth year the company reassessed the remaining useful life of the machinery at 4 years and residual value was estimated at 5% of original cost.

The accountant recalculated the revised depreciation historically and charged the difference to profit and loss account. You are required to comment on the treatment by accountant and calculate depreciation to be charged for the fourth year.

Question 19 *Pg no.*_____

Argon Ltd. purchased a shop on 1st January, 2007 at a cost of ₹ 8,50,000. The useful life of the shop is estimated as 30 years with residual value of ₹ 25,000 and depreciation is provided on a straight line basis. The shop was revalued on 30th June, 2021 for ₹ 19,50,000 and the revaluation was incorporated in the accounts. Calculate:

a) The surplus on revaluation;

b) Depreciation to be charged in the Profit and Loss account for the year ended on 31st December, 2021.

Question 20 *(ICAI Study Material)* *Pg no.*_____

Skanda Ltd. acquired a machinery for ₹ 2,50,00,000 five years ago. Depreciation was charged at 10% p.a. on SLM basis, useful life being 10 years. At the beginning of Year 3, the machinery was revalued to ₹ 3,00,00,000 with the surplus on revaluation being credited to Revaluation Reserve. Depreciation was provided on the revalued amount over the balance useful life of 8 years. The machinery was sold in the current year for ₹ 1,12,50,000. Give the accounting treatment for the above in the Company's accounts. What will be the treatment if the machinery fetched only ₹ 42,50,000 now?

Solution

Particulars	₹
Original Cost of the Asset	2,50,00,000
Less: Depreciation for 2 years (₹ 2,50,00,000 x 10% x 2 years)	(50,00,000)
Book Value at the beginning of Year 3	2,00,00,000
Add: Revaluation Surplus (balancing figure)	1,00,00,000
Revalued Amount as given (= revised depreciable value)	3,00,00,000
Less: Depreciation for Years 3-5 (₹ 3,00,00,000 ÷ 8 yrs x 3 yrs)	(1,12,50,000)
Carrying Amount at the end of Year 5	**1,87,50,000**

The treatment of Gain / Loss on Disposal / Revaluation is as below:

Particulars	Disposal Proceeds = ₹ 1,12,50,000	Disposal Proceeds = ₹ 42,50,000
Book Value Less Disposal Proceeds = Loss recognized in Profit or Loss	₹ 1,87,50,000 – ₹ 1,12,50,000 = ₹ 75,00,000 (Loss)	₹ 1,87,50,000 – ₹ 42,50,000 = ₹ 1,45,00,000 (Loss)
Revaluation Surplus directly transferred to Retained Earnings	₹ 1,00,00,000	₹ 1,00,00,000

Question 21 *(ICAI Study Material)* *Pg no._____*

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

Solution

Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with AS 10 (Revised). Entity A should separately recognise a receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 (Revised) once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

Question 22 *(RTP Nov 2022)* *Pg no._____*

RS Ltd. has acquired a heavy plant at a cost of ₹ 2,00,00,000. The estimated useful life is 10 years. At the end of the 2nd year, one of the major components i.e. the Boiler has become obsolete (which was acquired at price of ₹ 50,00,000) and requires replacement, as further maintenance is uneconomical. The remainder of the plant is perfect and is expected to last for next 8 years. The cost of a new boiler is ₹ 60,00,000.

Can the cost of the new boiler be recognised as an asset, and, if so, what should be the carrying value of the plant at the end of second year?

Solution

Recognition of Asset: The new boiler will produce economic benefits to RS Ltd., and the cost is measurable. Hence, the item should be recognized as an asset. The cost old boiler should be de-recognized and the new boiler will be added.

Statement showing cost of new boiler and machine after year 2

Particulars	₹
Original cost of plant	₹ 2,00,00,000
Less: Accumulated depreciation [(2,00,00,000 /10) x 2]	₹ 40,00,000
Carrying value of the plant after two years	₹ 1,60,00,000
Less: Current Cost of Old Boiler to be derecognized	
WDV of Boiler (replaced) after 2 years (50,00,000/10 x 8)	40,00,000
	1,20,00,000
Add: Cost of new Boiler to be recognized	60,00,000
Revised carrying amount of Plant	1,80,00,000

Question 23 *(ICAI Study Material) / (RTP Jan 2025) (Similar)* *Pg no.*_____

Bharat Infrastructure Ltd. acquired a heavy machinery at a cost of ₹ 1,000 lakhs, the breakdown of its components is not provided. The estimated useful life of the machinery is 10 years. At the end of Year 6, the turbine, which is a major component of the machinery, needed replacement, as further usage and maintenance was uneconomical. The remainder of the machine is in good condition and is expected to last for the remaining 4 years. The cost of the new turbine is ₹ 450 lakhs. Give the accounting treatment for the new turbine, assuming SLM Depreciation and a discount rate of 8%.

Solution

As per AS 10, Property, Plant and Equipment, the derecognition of the carrying amount of components of an item of Property, Plant and Equipment occurs regardless of whether the cost of the previous part / inspection was identified in the transaction in which the item was acquired or constructed. If it is not practicable for an enterprise to determine the carrying amount of the replaced part/ inspection, it may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/ existing inspection component was when the item was acquired or constructed.

In the given case, the new turbine will produce economic benefits to Bharat Infrastructure Ltd. and the cost is measurable. Since the recognition criteria is fulfilled, the same should be recognised as a separate item of Property, Plant and Equipment.

However, since the initial breakup of the components is not available, the cost of the replacement of ₹ 450 lakhs can be used as an indication based on the guidance given above, discounted at 8% for the 6-year period lapsed.

Thus, estimate of cost 6 years back = ₹ 450 lakhs ÷ 1.08^6 = ₹ 283.58 lakhs

Current carrying amount of turbine (to be de-recognised) =

Estimated cost ₹ 283.58 lakhs (-) SLM depreciation at 10% (useful life 10 years) for 6 years ₹ 170.15 lakhs= ₹ 113.43 lakhs.

Hence revised carrying amount of the machinery will be as under:

Particulars	₹ in lakhs
Historical Cost [₹ 1,000 lakhs (–) SLM Dep. at 10% for 6 years]	400.00
Add: Cost of new turbine	450.00
Less: Derecognition of current carrying amount of old turbine	(113.43)
New Carrying Amount of Machinery	**736.57**

Question 24 *(ICAI Study Material)* *Pg no.*_____

Akshar Ltd. installed a new Plant (not a qualifying asset), at its production facility, and incurred the following costs:

a. Cost of the Plant (as per supplier's invoice): ₹ 30,00,000
b. Initial delivery and handling costs: ₹ 1,00,000
c. Cost of site preparation: ₹ 2,00,000
d. Consultant fee for advice on acquisition of Plant: ₹ 50,000
e. Interest charges paid to supplier against deferred credit: ₹ 1,00,000
f. Estimate of Dismantling and Site Restoration costs: ₹ 50,000 after 10 years (Present Value is ₹ 30,000)
g. Operating losses before commercial production: ₹ 40,000

The company identified motors installed in the Plant as a separate component and a cost of ₹5,00,000 (Purchase Price) and other costs were allocated to them proportionately. The company estimates the useful life of the Plant and those of the Motors as 10 years and 6 years respectively and SLM method of Depreciation is used.

At the end of Year 4, the company replaces the Motors installed in the Plant at a cost of ₹ 6,00,000 and estimated the useful life of new motors to be 5 years. Also, the company revalued its entire class of Fixed Assets at the end of Year 4. The revalued amount of Plant as a whole is ₹ 25,00,000. At the end of Year 8, the company decides to retire the Plant from active use and also disposed the Plant as a whole for ₹ 6,00,000. There is no change in the Dismantling and Site Restoration liability during the period of use. You are required to explain how the above transaction would be accounted in accordance with AS 10.

Solution

Cost at Initial Recognition:

Particulars	₹
Cost of the Plant (as per Invoice)	30,00,000
Initial Delivery and Handling Costs	1,00,000
Cost of Site Preparation	2,00,000
Consultants' Fees	50,000
Estimated Dismantling and Site Restoration Costs	30,000
Total Cost of Plant including Motors	**33,80,000**
Less: Cost of Motors identified as a separate component (1/6)*	(5,63,333)
Cost of the Plant (excluding Motors – balance 5/6)	**28,16,667**

* Purchase price of Motors = ₹ 5,00,000 out of ₹ 30,00,000 i.e., 1/6 of value of Plant

Note: Since the asset is not a qualifying asset, payment of interest to the supplier is not capitalized. Further, operating losses of ₹ 40,000 incurred before commercial production is not a directly attributable cost, and hence excluded from cost of asset. These costs are expensed to the P/L as and when they are incurred.

1) Recognition of Motors Replacement

Particulars	₹
Cost of Motors determined above	5,63,333
Less: Depreciation for 4 years (as per SLM)	3,75,555
5,63,333 ÷ 6 years x 4 years	
Carrying Amount of Motors at the end of Year 4	**1,87,778**

Accounting: The company should derecognize the existing Carrying Amount of Motors replaced of ₹ 1,87,778. Further, the acquisition cost of new motors of ₹ 6,00,000 would be capitalized as a separate component. This amount will be depreciated over the next 5 years at ₹ 6,00,000 ÷ 5 years = ₹ 1,20,000 p.a.

2) Revaluation

Particulars	₹
Cost of the Plant at initial recognition [from (1) above]	28,16,667
Less: SLM Depreciation for 4 years: ₹ 28,16,667 ÷ 10 years x 4 years	(11,26,667)
Carrying Amount of Plant at the end of Year 4	16,90,000
Revalued Amount of Plant (Excluding Motors, since the same is treated as a separate component: ₹ 25,00,000 – ₹ 6,00,000)	19,00,000
Therefore, Gain on Revaluation credited to Revaluation Reserve	**2,10,000**
Revised Depreciation Charge p.a.: 19,00,000 ÷ 6 years	**3,16,667**

3) Derecognition

Particulars	Motors	Plant (excluding Motors)
Cost / Revalued Amount at end of Year 4	6,00,000	19,00,000
Less: Depreciation for Years 5-8	1,20,000 x 4 = 4,80,000	3,16,667 x 4 =12,66,668
Carrying Amount before Disposal / De- recognition	1,20,000	6,33,332
Less: Disposal Proceeds ₹ 6,00,000 allocated in ratio of carrying amount	95,575	5,04,425
Loss to be written off to P/L	**24,425**	**1,28,907**

Notes:

a. The Revaluation Surplus of ₹ 2,10,000 would be transferred directly to Retained Earnings.

b. The allocation of disposal proceeds of ₹ 6,00,000 for the plant as whole is apportioned based on carrying amount of motors and plant (excluding motors)

Alternatively, it may be apportioned as 1/6 towards motors and 5/6 plant (excluding motors) based on the reasoning that the initially, motors amounted to 1/6 of the entire plant. This approach may not be preferable because there has been a revaluation of the plant (excluding motors) and a disposal and subsequent acquisition of the Motor, which is not in the initial proportion of 5/6 and 1/6 respectively.

PRACTICE QUESTIONS

Question 1 *(Inter Nov 2018) (5 Marks)* *Pg no.*_____

Neon Enterprise operates a major chain of restaurants located in different cities. The company has acquired a new restaurant located at Chandigarh. The new-restaurant requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the restaurant will be closed. Management has prepared the following budget for this period –

Salaries of the staff engaged in preparation of restaurant before its opening ₹ 7,50,000 Construction and remodelling cost of restaurant ₹ 30,00,000.

Explain the treatment of these expenditures as per provisions of AS 10 "Property, Plant and Equipment".

Solution

As per provisions of AS 10, any cost directly attributable to bring the assets to the location and conditions necessary for it to be capable of operating in the manner indicated by the management are called directly attributable costs and would be included in the costs of an item of PPE.

Management of Neon Enterprise should capitalize the costs of construction and remodelling the restaurant, because they are necessary to bring the restaurant to the condition necessary for it to be capable of operating in the manner intended by management. The restaurant cannot be opened without incurring the construction and remodelling expenditure amounting ₹ 30,00,000 and thus the expenditure should be considered part of the asset.

However, the cost of salaries of staff engaged in preparation of restaurant ₹ 7,50,000 before its opening are in the nature of operating expenditure that would be incurred if the restaurant was open and these costs are not necessary to bring the restaurant to the conditions necessary for it to be capable of operating in the manner intended by management. Hence, ₹ 7,50,000 should be expensed.

Question 2 *(RTP May 2021)* *Pg no.*_____

You are required to give correct accounting treatment for the following in line with provisions of AS 10: Trozen Ltd. operates a major chain of supermarkets all over India. It acquires a new store in Pune which requires significant renovation expenditure. It is expected that the renovations will be done in 2 months during which the store will be closed. The budget for this period, including expenditure related to construction and remodelling costs (₹ 18 lakhs), salaries of staff (₹ 2 lakhs) who will be preparing the store before its opening and related utilities costs (₹ 1.5 lakhs), is prepared. The cost of salaries of the staff and utilities are operating expenditures that would be incurred even after the opening of the supermarket. What will the treatment of all these expenditures in the books of accounts?

Solution

Trozen Ltd. should capitalize the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended. The supermarket cannot be opened without incurring the remodelling expenditure. Therefore, this construction and remodelling expenditure of ₹ 18 lakh should be considered as part of the cost of the asset. However, the cost of salaries of the staff ₹ 2 lakh and utilities cost ₹ 1.5 lakh are operating expenditures that would be incurred even after the opening of the supermarket. Therefore, these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by the management and should be expensed.

Question 3 *(RTP May 2020)* *Pg no._____*

The following items are given to you:

ITEMS

(1) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment);

(2) Costs of conducting business in a new location or with a new class of customer (including costs of staff training);

(3) Costs of opening a new facility or business, such as, inauguration costs;

(4) Purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

With reference to AS 10 "PPE", classify the items under the following heads:

(i) Purchase Price of PPE

(ii) Directly attributable cost of PPE or

(iii) Cost not included in determining the carrying amount of an item of PPE.

Solution

(1) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment) will be classified as "Directly attributable cost of PPE".

(2) Costs of conducting business in a new location or with a new class of customer (including costs of staff training) will be classified under head (iii) as it will not be included in determining the carrying amount of an item of PPE.

(3) Costs of opening a new facility or business, such as, inauguration costs will be classified under head (iii) as it will not be included in determining the carrying amount of an item of PPE.

(4) Purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates will be included in determination of Purchase Price of PPE.

Question 4 *(RTP May 2022)* *Pg no._____*

A Ltd. has incurred the following costs. Determine if the following costs can be added to the invoiced purchase price and included in the initial recognition of the cost of the item of property, plant and equipment:

1. Import duties paid
2. Shipping costs and cost of road transport for taking the machinery to factory
3. Insurance for the shipping
4. Inauguration costs for the factory
5. Professional fees charged by consulting engineer for the installation process
6. Costs of advertising and promotional activities
7. Administration and other general overhead costs
8. Cost of site preparation.

Solution

Included in Cost: Point no. 1,2,3,5,8

Excluded from Cost: Point no. 4,6,7

Question 5 *(RTP Nov 2018)* *Pg no._____*

ABC Ltd. is installing new plant at its production factory. It provides you following information:

Cost of the plant (cost per supplier's invoice plus taxes)	31,25,000
Estimated dismantling costs to be incurred after 5 years	2,50,000
Initial Operating losses before commercial production	3,75,000
Initial delivery and handling costs	1,85,000
Cost of site preparation	4,50,000
Consultants used for advice on the acquisition of the plant	6,50,000

Please advise ABC Ltd. on the costs that can be capitalised for plant in accordance with AS 10: Property, Plant and Equipment.

Solution

As per AS 10 'Property, Plant and Equipment', the costs to be capitalized by ABC Ltd. are:

Cost of the plant (cost per supplier's invoice plus taxes)	31,25,000
Estimated dismantling costs to be incurred after 5 years	2,50,000
Initial delivery and handling costs	1,85,000
Cost of site preparation	4,50,000
Consultants used for advice on the acquisition of the plant	6,50,000
	46,60,000

Note: Operating losses before commercial production amounting to ₹ 3,75,000 will not be capitalized as per AS 10. They should be written off to the Statement of Profit and Loss in the period they are incurred.

Question 6 *(RTP Nov 2020) / (ICAI Study Material)* *Pg no._____*

Omega Ltd. contracted with a supplier to purchase machinery which is to be installed in its one department in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were ₹ 1,40,000. These activities were supervised by a technician during the entire period, who is employed for this purpose of ₹ 45,000 per month.

The machine was purchased at ₹ 1,58,00,000 and ₹ 50,000 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of ₹ 30,000 to supervise machinery installation at the factory site.

You are required to ascertain the amount at which the Machinery should be capitalized.

Solution

Particulars		Amount
Purchase Price	Given	1,58,00,000
Add: Site Preparation Cost	Given	1,40,000
Technician's Salary	Specific/Attributable overheads for 3 months (45,000 x3)	1,35,000
Initial Delivery Cost	Transportation	50,000
Professional Fees for Installation	Architect's Fees	30,000
Total Cost of Asset		**1,61,55,000**

Question 7 *(Inter July 2021) (5 Marks)* *Pg no._____*

(i) A Limited has contracted with a supplier to purchase machinery which is to be installed at its new plant in four months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were ₹ 2,10,000. These activities were supervised by an Architect during the entire period, who is employed for this purpose at a salary of ₹ 35,000 per month. The machinery was purchased for ₹ 1,27,50,000 and a sum of ₹ 2,12,500 was incurred towards transportation charges to bring the machinery to the plant site. An

Engineer was appointed at a fees of ₹ 37,500 to supervise the installation of the machinery at the plant site. You are required to ascertain the amount at which the machinery should be capitalized in the books of A Limited.

(ii) B Limited, which operates a major chain of retail stores, has acquired a new store location. The new location requires substantial renovation expenditure. Management expects that the renovation will last for 4 months during which the store will be closed. Management has prepared the budget for this period including expenditure related to construction and re-modelling costs, salary of staff who shall be preparing the store before its opening and related utilities cost. How would such expenditure be treated in the books of B Limited?

Solution

(i) Showing the Computation of the amount at which the Machinery should be capitalized in the books of A Limited

Particulars		Amount (₹)
Purchase cost of machinery	Given	1,27,50,000
Add: Site Preparation Cost	Given	2,10,000
Architect's Salary	Specific/ Attributable overheads for 4 months (₹ 35,000 x 4)	1,40,000
Initial Delivery Cost	Transportation	2,12,500
Professional Fees for Installation	Engineer's Fees	37,500
Total Cost of Machinery to be capitalized		**1,33,50,000**

(ii) Management should capitalize the costs of construction and remodelling the store, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The store cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset. However, if the cost of salaries, utilities and storage of goods are in the nature of operating expenditure that would be incurred if the store was open, then these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Question 8 *(ICAI Study Material)* *Pg no.*_____

Entity B constructs a machine for its own use. Construction is completed on 1st November 2021 but the company does not begin using the machine until 1st March 2022. Comment

Solution

The entity should begin charging depreciation from the date the machine is ready for use – that is, 1st November 2021. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

Question 9 *Pg no.*_____

In the year 2021-22, an entity has acquired a new freehold building with a useful life of 25 years for ₹ 45,00,000. The entity desires to calculate the depreciation charge per annum using a straight-line method. It has identified the following components (with no residual value of lifts & fixtures at the end of their useful life) as follows:

Component	Useful life (Years)	Cost
Land	Infinite	10,00,000
Roof	25	5,00,000

Lifts	10	2,50,000
Fixtures	5	2,50,000
Remainder of building	25	25,00,000
		45,00,000

(i) Calculate depreciation for the year 2021-22 as per componentization method.
(ii) Also state the treatment, in case Roof requires replacement at the end of its useful life.

Solution

(i) **Statement showing amount of depreciation as per Componentization Method**

Component	Depreciation = Cost / Useful life	Depreciation (p.a.)
Land	-	Nil
Roof	5,00,000/25	20,000
Lifts	2,50,000/10	25,000
Fixtures	2,50,000/5	50,000
Remainder of building	25,00,000/25	1,00,000
		1,95,000

(ii) When the roof requires replacement at the end of its useful life, the carrying amount will be Nil. The cost of replacing the roof should be recognised as a new component.

Question 10 *(ICAI Study Material) / (RTP Nov 2021) (Similar)* *Pg no._____*

A property costing ₹ 10,00,000 is bought in 2021. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years.
The estimated residual value in 20 years' time, based on 2021 prices, is:
Case (a) ₹ 10,00,000 Case (b) ₹ 9,00,000
Calculate the amount of depreciation.

Solution

Case (a)
The company considers that residual value, based on prices prevailing at the balance sheet date, will equal the cost. There is, therefore, no depreciable amount and depreciation is zero.

Case (b)
The company considers that the residual value, based on prices prevailing at the balance sheet date, will be ₹ 9,00,000 and the depreciable amount is, therefore, ₹ 1,00,000.
Annual depreciation (on a straight line basis) will be ₹ 5,000 [{10,00,000 – 9,00,000} ÷ 20].

Question 11 *(RTP May 2020) / (ICAI Study Material)* *Pg no._____*

Entity A purchased an asset on 1st January 2018 for ₹ 1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil. On 1st January 2022, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years. Calculate amount of depreciation for each year, if company charges depreciation on Straight Line basis.

Solution

The entity has charged depreciation using the SLM at ₹ 10,000 p.a. i.e (1,00,000/10 years).
On 1st January 2022, the asset's net book value is [1,00,000 – (10,000 x 4)] ₹ 60,000.
Remaining useful life is 4 years. The company should amend annual provision for depreciation to charge the unamortised cost over the revised remaining life of 4 years. Consequently, it should charge depreciation for the next 4 years at ₹ 15,000 per annum i.e. (60,000 / 4 years).

Question 12 *(ICAI Study Material)* *Pg no.*_____

Arka Ltd. purchased machinery for ₹ 3,000 lakhs. Depreciation was charged at 10% on SLM basis for a useful life of 10 years. At the end of Year 4, the machinery was revalued to ₹ 2,700 lakhs and the same was adopted. What will be the carrying amount of the asset at the end of Year 5 and Year 6? Assume no change in the useful life.

Solution

Particulars	₹ in lakhs
Original Cost of the Asset	3,000.00
Less: Depreciation for 4 years (₹ 3,000 lakhs x 10% x 4 years)	(1,200.00)
Book Value at the end of Year 4	1,800.00
Add: Revaluation Surplus (balancing figure)	900.00
Revalued Amount as given (= revised depreciable value)	2,700.00
Less: Depreciation for Year 5 (₹ 2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 5	2,250.00
Less: Depreciation for Year 6 (₹ 2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 6	1,800.00

Question 13 *Pg no.*_____

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 the company. As a result, the residual value will reduce to ₹ 10,000. How would the above changes in estimates be made by B Ltd.?

Solution

The asset has a carrying amount of ₹ 56,000 at the end of year 8 [₹ 2,00,000 – ₹ 1,44,000] i.e. Accumulated Depreciation. **Accumulated depreciation is calculated as**
Depreciable amount {Cost less residual value} = ₹ 2,00,000 – ₹ 20,000 = ₹ 1,80,000.
Annual depreciation = Depreciable amount / Useful life = 1,80,000 / 10 = ₹ 18,000.
Accumulated depreciation = 18,000 × No. of years (8) = ₹ 1,44,000.
Revision of the useful life to 12 years results in a remaining useful life of 4 years (12 – 8).
The revised depreciable amount is ₹ 46,000. (56,000 – 10,000)
Thus, depreciation should be charged in future at ₹ 11,500 per annum (₹ 46,000/4 years).

Question 14 *(Inter Nov 2020) (5 Marks)* *Pg no.*_____

A Ltd. had following assets. Calculate depreciation for the year ended 31st March, 2022 for each asset as per AS 10 (Revised):

a) Machinery purchased for ₹ 10 lakhs on 1st April, 2017 and residual value after useful life of 5 years, based on 2017 prices is ₹ 10 lakhs.
b) Land for ₹ 50 lakhs.
c) Machinery is constructed for ₹5,00,000 for its own use (useful life is 10 years). Construction is completed on 1st April, 2021, but the company does not begin using the machine until 31st March, 2022.
d) Machinery purchased on 1st April, 2019 for ₹ 50,000 with useful life of 5 years & residual value is Nil. On 1st April, 2021, management decided to use this asset for further 2 years only

Solution **Computation of Amount of Depreciation as per AS 10**

		Amount
(i)	Machinery purchased on 1/4/17 for ₹ 10 lakhs (having residual value of ₹ 10 lakhs) **Reason:** The company considers that residual value, based on prices prevailing at the balance sheet date, will equal the cost. Therefore, thereis no depreciable amount and depreciation is correctly zero.	Nil
(ii)	Land (50 lakhs) (considered freehold) **Reason:** Land has an unlimited useful life and therefore, it is not depreciated.	Nil
(iii)	Machinery constructed for own use (₹5,00,000/10) **Reason:** The entity should begin charging depreciation from the date the machine is ready for use i.e. 1st April, 2021. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.	50,000
(iv)	Machinery having revised useful life **Reason:** The entity has charged depreciation using the SLM at 10,000 p.a. i.e (50,000/5 years). On 1st April, 2021 the asset's net book value is [50,000 – (10,000 x 2)] i.e. ₹ 30,000. The remaining useful life is 2 years as per revised estimate. The company should amend annual provision for depreciation to charge unamortized cost over revised remaining life of 2 years. Consequently, it should charge depreciation for the next 2 years at ₹ 15,000 per annum i.e. (30,000 / 2 years).	15,000

Question 15 *(Inter May 2022) (5 Marks)* *Pg no.*_____

XYZ Limited provided you the following information for the year ended 31 st March, 2022.

(i) The carrying amount of a property at the end of the year amounted to ₹ 2,16,000 (cost/value ₹ 2,50,000 and accumulated depreciation ₹ 34,000). On this date the property was revalued and was deemed to have a fair value of ₹ 1,90,000. The balance in the revaluation surplus relating to a previous revaluation gain for this property was ₹ 20,000. You are required to calculate revaluation loss as per AS 10 and give its treatment in the books of accounts.

(ii) An asset that originally cost ₹ 76,000 and had accumulated depreciation of ₹ 62,000 was disposed of during the year for ₹ 4,000 cash.
You are required to explain how the disposal should be accounted for in the financial statements as per AS 10 (Revised).

Solution

(i) As per AS 10, a decrease in the carrying amount of an asset arising on revaluation should be charged to the statement of profit and loss. However, the decrease should be debited directly to owners' interests under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Calculation of revaluation loss and its accounting treatment

		₹
Carrying value of the asset as on 31st March, 2022	a	2,16,000
Revalued amount of the asset	b	(1,90,000)
Total revaluation loss on asset	c=a-b	26,000
Adjustment of previous revaluation reserve	d	(20,000)
Net revaluation loss to be charged to the Profit & loss account	e=c-d	6,000

(ii) AS 10 states that the carrying amount of an item of property, plant and equipment is derecognized on disposal of the asset. It further states that the gain or loss arising from the derecognition of an item of property, plant and equipment should be included in the statement of profit and loss when the item is derecognized. Gains should also not be classified as revenue.

Calculation of loss on disposal of the asset and its accounting treatment

		₹
Original cost of the asset	a	76,000
Accumulated depreciation till date	b	62,000
Carrying value of the asset as on 31st March, 2022	c=a-b	14,000
Cash received on disposal of the asset	d	4,000
Loss on disposal of asset charged to the Profit and loss account	e=c-d	10,000

Question 16 *(Inter May 2023) (5 Marks)* *Pg no._____*

In the books of Topmaker Limited, carrying amount of Plant and Machinery as on 1st April, 2022 is ₹ 56,30,000.

On scrutiny, it was found that a purchase of Machinery worth ₹ 21,12,000 was included in the purchase of goods on 1st June, 2022. On 30th June, 2022 the company disposed a Machine having book value of ₹ 9,60,000 (as on 1st April, 2022) for ₹ 8,25,000 in part exchange of a new machine costing ₹ 15,65,000.

The company charges depreciation @ 10% p.a. on written down value method on Plant and Machinery.

You are required to compute:

(a) Depreciation to be charged to Profit & Loss Account.

(b) Book value of Plant & Machinery as on 31st March, 2023; and

(c) Profit/Loss on exchange of Plant & Machinery.

Solution

(i) Depreciation to be charged in the Profit & Loss Account

Particulars	Amount in ₹
Depreciation on old Machinery	1,40,750
[10% on ₹ 56,30,000 for 3 months (01.04.2022 to 30.06.2022)]	
Add: Depreciation on Machinery acquired on 01.06.2022	1,76,000
(₹21,12,000 X 10% X10/12)	
Add: Depreciation on Machinery after adjustment of Exchange	4,67,625
[10% of ₹ 56,30,000 – 9,60,000 + 15,65,000) for 9 months]	
Total Depreciation to be charged in Profit & Loss A/c	7,84,375

(ii) Book value of Plant & Machinery as on 31.3.2023

Particulars		Amount in ₹
Balance as per books on 01.04.2022		56,30,000
Add: Included in purchases on 01.06.2022	21,12,000	
Add: Purchases on 30.06.2022	15,65,000	36,77,000
		93,07,000
Less: Book value of Machine sold on 30.06.2022		(9,60,000)
		83,47,000
Less: Depreciation on Machinery in use ₹ (7,84,375 -24,000)		(7,60,375)
Book Value as on 31.03.2023		75,86,625

Note: The computation of depreciation and book value of Plant & Machinery can be presented in the following alternative manner:

Particulars	Book Value or Cost or Acquisition	Period	Depreciation	Book Value as on 31.03.2023
Opening Value	46,70,000 (56,30,000 – 9,60,000)	01.04.2022 to 31.03.2023	4,67,000 (46,70,000 x 10%)	42,03,000
Sold	9,60,000	01.04.2022 to 30.06.2022	24,000 (9,60,000 x 10% x 3/12)	-
Purchases	21,12,000	01.06.2022 to 31.03.2023	1,76,000 (21,12,000 x 10% x 10/12)	19,36,000
New Machinery	15,65,000	01.07.2022 to 31.03.2023	1,17,375 (15,65,000 x 10% x 9/12)	14,47,625
Total			**7,84,375**	**75,86,625**

(iii) Profit/Loss on Exchange of Machinery

Particulars	Amount in ₹
Balance as per books on 01.04.2022	9,60,000
Less: Depreciation for 3 months (₹ 9,60,000 x 10 /100 x 3 / 12)	(24,000)
W.D.V. as on 30.06.2022	9,36,000
Less: Exchange value	(8,25,000)
Loss on Exchange of Machinery	1,11,000

Question 17 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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

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

Question 18 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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

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

Question 19 *(ICAI Study Material)* *Pg no.*_____

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

Solution

As per AS 10, Property, Plant and Equipment, depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. In the given case, since the plant is ready for commercial production in November, depreciation shall commence from November. The date of commencement of commercial production is irrelevant for charging depreciation.

Question 20 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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

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

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

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

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

Question 21 *(ICAI Study Material)* *Pg no.*_____

An entity gave the following Note in its Financial Statements:

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

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

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

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

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

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

Solution

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

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

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

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

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

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

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

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

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

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

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

The value of any asset, after usage, will reduce. Accordingly, the argument that the 'exact profit or loss on sale of the asset' will be obtained is incorrect. Due to usage of the asset,

the value of the asset would be lower than the cost. Charging depreciation would seek to bring the book value approximating to such reduced value. Thereafter, on sale of the asset, the true profit or loss would be available. Accordingly, this argument is also invalid. It may be pertinent to note that Accounting Standard 1, Disclosure of Accounting Policies states that Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts. In other words, the company cannot be absolved of the fact that it has not complied with the relevant accounting standards merely by giving a disclosure of incorrect policies or practices being followed.

Thus, the company's stand of disclosing the incorrect policy as a remedy is not correct. The company is suggested to charge depreciation on a systematic basis over the useful life of the asset thereby complying with the Accounting Standards.

Question 22 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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

Question 23 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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

THE EFFECT OF CHANGES IN FOREIGN EXCHANGE RATES

AS 11

Scope	AS-11 should be applied in ❖ Accounting for transactions in foreign currencies ❖ Translating the financial statements of foreign operations. ❖ Accounting for foreign currency transactions in the nature of forward exchange contracts	
FOREIGN CURRENCY TRANSACTIONS		
Meaning	It is a transaction which is denominated or requires settlement in a foreign currency.	
Examples	➢ Buying and selling of goods or services in foreign currency ➢ Lending or borrowing in foreign currency. ➢ Acquisition and disposition of asset denominated in foreign currency.	
Initial recognition	→ All transactions should be recorded at **spot rate** i.e. rate of foreign exchange at the date of transaction. → If spot rate is not given then average rate of week or month can be used	
Subsequent recognition /reporting at subsequent balance sheet dates	***Monetary Item***	These are the items which are receivable or payable in fixed or determinable amounts of money. **Example:** Cash, debtors, creditors, etc. ***Use exchange rate at the balance sheet date***
	Non-monetary item	These all assets and liabilities other than monetary items. **Example:** Fixed assets, inventories and investments in equity shares. ***Use exchange rate at the date of transaction.*** **If item carried at fair value, then use the exchange rate that existed when the values were determined**
Recognition of exchange differences	***Monetary Item***	To be recognized as expenses or income i.e. to be debited or credited to P & L A/c
	Non-monetary item	No subsequent recognition is required, there does not arise any exchange difference.
SPECIAL CASE (MONETARY ITEMS) PARA 46/46A		
Applicability	Exchange differences arising or reporting of long-term foreign currency monetary items. (LTFCMI). Application of this Para is optional but once exercised it is irrevocable & applies to all such foreign currency monetary items.	
Meaning of LTFCMI	An asset or liability should be designated as LTFCMI if – ➢ Asset or liability is expressed in a foreign currency and ➢ Has a **term of 12 months or more** at the date of origination of the asset or liability.	
Exchange difference on LTFCMI	***Related to depreciable capital assets***	Add to/deduct from cost of asset and depreciate over the balance life of the asset

	Others	Accumulate in FCMITDA and amortize over the balance period of such long term item FCMITDA: Foreign Currency Monetary Item Translation Difference Account *Disclosed under Reserve & Surplus as separate line item*
Disclosure requirements	• Fact of such option • Amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.	
FOREIGN OPERATIONS		
Integral Foreign Operations	• It is a foreign operation, the activities of which are integral part of those of the reporting enterprise. The business of IFO is carried on as if it were an extension of the reporting enterprises operations.	
Non- Integral Foreign Operations	• It is a foreign operation that is not an integral foreign operation. The business of NIFO is carried on in substantially independent way by accumulating cash & other monetary items, incurring expenses, generating income & arranging borrowing in its own local currency.	
FORWARD EXCHANGE CONTRACTS		
Meaning	It means agreement to exchange different currencies at a forward rate. Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.	
Categories	***For Trading or speculation purposes***	Gain or loss recognized in the Statement of P&L for the period. The premium or discount on the forward exchange contract is not recognised separately. At each balance sheet date the value of contract is marked to its current market value and the gain or loss on the contract is recognised.
	Not for Trading or speculation	Premium or discount – amortize as expense or income over the life of contract.

DISCLOSURE REQUIREMENTS

- An enterprise should disclose:
  (a) The amount of exchange differences included in the net profit or loss for the period.
  (b) Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.
- When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.
- When there is a change in the classification of a significant foreign operation, an enterprise should disclose:
  (a) The nature of the change in classification
  (b) The reason for the change
  (c) The impact of the change in classification on shareholders' funds and
  (d) The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

ASSIGNMENT QUESTIONS

Question 1 *(RTP Nov 2018) / (RTP Nov 2020) (ICAI Study Material)* *Pg no.*_____

	Exchange Rate per $
Goods purchased on 1.1.2021 of US $ 15,000	₹ 75
Exchange rate on 31.3.2021	₹ 74
Date of actual payment 7.7.2021	₹ 73

Ascertain the loss/gain for financial years 2020-21 and 2021-22, also give their treatment as per AS 11. Pass Journal entries.

Question 2 *(RTP Nov 2022)* *Pg no.*_____

A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2021, when the exchange rate was ₹ 43 per US Dollar. The company had recorded the transaction in the books at the above-mentioned rate. The payment for the import transaction was made on 5th April, 2021 when the exchange rate was ₹ 47 per US Dollar. However, on 31st March, 2021, the rate of exchange was ₹ 48 per US Dollar. The company passed an entry on 31st March, 2021 adjusting the cost of raw materials consumed for the difference between ₹ 47 and ₹ 43 per US Dollar.

In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss

Question 3 *(ICAI Study Material) / (RTP May 2022) (Sim.)* *Pg no.*_____

Kalim Ltd. borrowed US$ 4,50,000 on 01/01/2021, which will be repaid as on 31/07/2021. Kalim Ltd. prepares financial statement ending on 31/03/2021. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/2021 1 US$ = ₹ 48.00 31/03/2021 1 US$ = ₹ 49.00 31/07/2021 1 US$ = ₹ 49.50

Pass Journal entries.

Question 4 *(ICAI Study Material)* *Pg no.*_____

A Ltd. has borrowed USD 10,000 in foreign currency on April 1, 2021 at 5% p.a. annual interest and acquired a depreciable asset. The exchange rates are as under:

01/04/2021 1 US$ = ₹ 48.00

31/03/2022 1 US$ = ₹ 51.00

You are required to pass the journal entries in the following cases:

(i) Option under Para 46A is not availed.

(ii) Option under Para 46A is availed.

(iii) The loan was taken to finance the operations of the entity (and not to procure a depreciable asset).

In all cases, assume interest accrued on 31 March 2022 is paid on the same date.

Question 5 *(RTP Nov 2019) / (ICAI Study Material)* *Pg no.*_____

Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3.2021

a) Trade receivables include amount receivable from Umesh ₹ 5,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $ 1= ₹ 58.50.

b) Long term loan taken from a U.S. Company, amounting to ₹ 60,00,000. It was recorded at US $ 1 = ₹ 55.60, taking exchange rate prevailing at the date of transaction.

US $ 1 = ₹ 61.20 on 31.3.2021.

Question 6

Pg no._____

Beekay Ltd. purchased fixed assets costing ₹ 5,000 lakh on 01.04.2021 payable in foreign currency (US$) on 05.04.2022. Exchange rate of 1 US$ = ₹ 50.00 and ₹ 54.98 as on 01.04.2021 and 31.03.2022 respectively. The company also obtained a soft loan of US$ 1 lakh on 01.04.2021 payable in three annual equal instalments. First instalment was due on 01.05.2022.

You are required to state, how these transactions would be accounted for in the books of accounts ending 31st March, 2022.

Question 7

Pg no._____

Legal Ltd. is engaged in the manufacturing of rubber. For its plant, it required machineries of latest technology. It usually resorts to Long Term Foreign Currency Borrowings for its fund requirements. On 1st April, 2021, it borrowed US $1 million from International Funding Agency, USA when exchange rate was 1 $ = ₹ 63. The funds were used for acquiring machineries, on the same date, to be used in three different plants. The useful life of the machineries is 10 years and their residual value is ₹ 30,00,000.

Earlier also the company used to purchase machineries out of foreign borrowings. The exchange differences arising on such borrowings were charged to P&L A/c and were not capitalized even though the company had an option to capitalize it as per notified AS 11.

Now for this new purchase of machinery, Legal Ltd, is interested to avail the option of capitalizing the same to the cost of asset. Exchange rate on 31st March, 2022 is 1 US $ = ₹ 62. Assume that on 31st March, 2022, Legal Ltd. is not having any old long term foreign currency borrowings except for the amount borrowed for machinery purchased on 1st April, 2021.

Comment whether Legal Ltd. can capitalize the exchange difference to the cost of asset on 31st March, 2022. If yes, then calculate the depreciation amount on machineries as on 31st March, 2022.

Solution

As per paragraph 46A of AS 11, 'The Effects of Changes in Foreign Exchange Rates', the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, though Legal Ltd. had not earlier exercised the option, yet it can avail the option to capitalize the exchange difference to the cost of machinery by virtue of para 46A of AS 11. Further, since Legal Ltd. has no earlier long term foreign currency borrowings, it is not required to apply capitalization option to earlier borrowing also.

Exchange difference to be capitalized and depreciation amount

Cost of the asset in $	1 million
Exchange rate on 1st April, 2021	1$ = ₹ 63
Cost of the asset in ₹ (1 million x ₹ 63)	63 million
Less: Exchange differences as on 31st March, 2022 (63-62) x $ 1 million (Gain)	(1 million)
	62 million
Less: Depreciation for 2021-22 (62 million - 3 million) /10 years	(5.90 million)
	56.10 million

Question 8 *(RTP Sep 2024)* *Pg no._____*

Alfa Ltd. purchased an item of property, plant and equipment for US $ 50 Lakh on 01.04.2023 and the same was fully financed by the foreign currency loan (US $) repayable in 5 equal instalments annually. Exchange rate at the time of purchase was 1 US $ = ₹ 60. As on 31.03.2024 the first instalment was paid when 1 US $ = ₹ 62.

The entire loss on exchange was included in cost of goods sold. Om Ltd. normally provides depreciation on an item of property, plant and equipment at 20% on WDV basis and exercised the option to adjust the cost of asset for exchange difference arising out of loan restatement and payment.

Calculate the amount of exchange loss, its treatment and depreciation on this item of property, plant and equipment.

Solution

Exchange differences arising on restatement or repayment of liabilities incurred for the purpose of acquiring an item of property, plant and equipment should be adjusted in the carrying amount of the respective item of property, plant and equipment as Om Ltd. has exercised the option and it's a long term foreign currency monetary item.

Thus the entire exchange loss due to variation of ₹ 20 Lakh on 31.03.2024 on payment of US $10 Lakh, should be added to the carrying amount of an item of property, plant and equipment and not to the cost of goods sold. Further depreciation on unamortized depreciable amount should also be provided.

Calculation of Exchange Loss:

Foreign Currency Loan (in ₹) = $ 50 Lakh x 60 = ₹ 3,000 Lakh

Exchange Loss on outstanding loan on 31.03.2024 = US $ 40 Lakh x (62-60) = ₹ 80 Lakh

So ₹ 80 Lakh should also be added to cost of an item of property, plant and equipment with corresponding credit to outstanding loan in addition to ₹ 20 Lakh on account of exchange loss on payment of instalment. The total cost of an item of property, plant and equipment to be increased by ₹ 100 Lakh.

Total depreciation to be provided for the year 2023-24 = 20% of (3,000+100) = ₹ 620 Lakh.

Question 9 *(RTP Nov 2018)/(RTP Nov 2020)/(RTP Nov 2023)/(ICAI Study Material)* *Pg no._____*

Explain "monetary item" as per Accounting Standard 11. How are foreign currency monetary items to be recognized at each Balance Sheet date? Classify the following as monetary or non-monetary item:

(i) Share Capital
(ii) Investment in Equity Shares
(iii) Trade Receivables
(iv) Property, Plant & Equipment.

Solution

As per AS 11, Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Foreign currency monetary items should be reported using the closing rate at each balance sheet date.

Share capital	Non-monetary
Trade receivables	Monetary
Investment in Equity Shares	Non-monetary
Property, Plant & Equipment	Non-monetary

Question 10 *(ICAI Study Material) / (RTP May 2019) / (RTP Nov 2021) (Similar)* *Pg no._____*

Rau Ltd. purchased a plant for US$ 1,00,000 on 01st February 2021, payable after three months. Company entered into a forward contract for three months @ ₹ 49.15 per dollar. Exchange rate per dollar on 01st Feb. was ₹ 48.85. How will you recognize the profit or loss on forward contract in the books of Rau Ltd.

Solution

Calculation of profit or loss to be recognized in the books of Rau Ltd.

	₹
Forward contract rate	49.15
Less: Spot rate	(48.85)
Loss/Premium on Contract	0.30
Forward Contract Amount	$1,00,000
Total loss on entering into forward contract = ($1,00,000 × ₹ 0.30)	₹ 30,000
Contract period	3 months
Loss for the period 1st February, 2021 to 31st March, 2021 i.e. 2 months falling in the year 2020-2021 will be ₹ 30,000*2/3 =	₹ 20,000

Balance loss of ₹ 10,000 (i.e. ₹ 30,000 – ₹ 20,000) for the month of April, 2021 will be recognized in the financial year 2021-2022.

Question 11 *(ICAI Study Material)* *Pg no._____*

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

Solution

As per AS 11, in recording a forward exchange contract intended for trading or speculation purpose, the premium or discount on the contract is ignored and at each balance sheet date, the value of contract is marked to its current market value and the gain or loss on the contract is recognised. Since the forward contract was for speculation purposes the premium on forward contract i.e. the difference between the spot rate and the forward contract rate will not be recorded in the books.

Only when the forward contract is sold the difference between the forward contract rate and sale rate will be recorded in the Profit & Loss Account.

	₹
Sale rate	47.18
Less: Contract rate	(47.10)
Profit on sale of contract per US$	00.08

Contract Amount US $ 1,00,000

Total profit (1,00,000 x 0.08) ₹ 8,000

Question 12 *Pg no._____*

"The company had a engineering contract with a foreign government, work to be carried out in foreign country and payments to be received in dollars. The work was completed in the year 2021, and the entire contracted amount was duly recorded in the books of the company at the prevalent exchange rate on the date of completion of the work. However, payments to the extent of ₹ 40 crores could not be released by the Foreign Government because of

temporary foreign exchange crisis in that country. These ₹40 crores unrealized at the end, if converted at the yearend rate would amount to ₹ 40.50 crores. The Company has adopted and follows the following accounting policy:
"In respect of foreign currency transactions, current assets and current liabilities are revalued at year end rates. However, if there is a net loss, due to exchange difference, the same is charged off to the P&L account, but if there is a net gain, the same is ignored in view of the prudent accounting policies of not recording unrealized gains due to exchange rate fluctuations".
Comment on the appropriateness of the above.

Solution

In given case the recoverability of ₹ 40 Crores is not doubtful or uncertain but just deferred temporarily hence it should be translated using exchange rates at the close of the year. Further AS-11 clearly mentions that net difference shall be transferred to profit and loss account. Hence, we can say that exchange difference favourable or unfavorable both shall be considered at the yearend rather to ignore the gains and recording just losses.

Question 13 *(Inter May 2023) (5 Marks)* *Pg no._____*

Trower Limited is an Indian importer. It imports goods from True View Limited situated at London. Trower Limited has a payable of £ 50,000 to True View Limited as on 31st March, 2023. True View Limited has given Trower Limited the following two options:
(a) Pay immediately with a cash discount of 1% on the payable.
(b) Pay after 6 months with interest @ 5% p.a. on the payable.
The borrowing rate for Trower Limited in rupees is 15% p.a.
The following are the exchange rates :

Date	**₹/£**
31st March, 2023	97
30th September, 2023	99

You are required to give your opinion to Trower Limited on which of the above two options to be chosen.

Solution

Option (i) Pay immediately with Cash discount of 1% on the payable

	₹
Total amount payable on 31.3.2023	50,000
Less: Cash discount (50,000 x 1 / 100)	(500)
	49,500
49,500 x ₹ 97	48,01,500
Add: Borrowing cost @ 15% p.a. for 6 months	3,60,112.50
If payment made immediate	51,61,612.50

Option (ii) Pay after 6 months with interest @ 5% p.a. on the payable

	₹
Total amount payable on 31.3.2023	50,000
Interest for 6 months @ 5% (50,000 x 5 / 100 x 6 / 12)	1,250
	51,250
If payment made after 6 months (51,250 x 99)	50,73,750

Thus, Option (ii) is beneficial to Trower Limited as the Rupee outflow will be lower by ₹ (51,61,612 – 50,73,750) = ₹ 87,862 in option (ii).

PRACTICE QUESTIONS

Question 1 *(RTP Jan 2025)* *Pg no.*_____

Bansal Company Ltd. imported raw material worth US Dollars 12,000 on 15th January, 2024 when the exchange rate was ₹ 68 per US Dollar. The payment for the transaction was made on 5th May, 2024 when exchange rate was ₹ 64 per US Dollar. At the year end, 31st March, 2024, the rate of exchange was ₹ 65 per US Dollar.

The accountant of the company passed entry on 31st March, 2024 adjusting the cost of raw material consumed for the difference between ₹ 64 and ₹ 68 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11 (Revised).

Solution

As per AS 11, 'The Effects of Changes in Foreign Exchange Rates', initial recognition of a foreign currency transaction is done in the reporting currency by applying the exchange rate at the date of the transaction. Accordingly, on 15th January, 2024, the raw material purchased and its creditors will be recorded at US dollar 12,000 × ₹ 68 = ₹ 8,16,000.

Also, on balance sheet date such transaction is reported at closing rate of exchange, hence it will be valued at the closing rate i.e. ₹ 65 per US dollar (USD 12,000 x ₹ 65 = ₹ 7,80,000) at 31st March, 2024, irrespective of the payment made for the same subsequently at lower rate in the next financial year.

The difference of ₹ 3 (65 – 68) per US dollar i.e. ₹ 36,000 (USD 12,000 x ₹ 3) will be shown as an exchange gain in the profit and loss account for the year ended 31st March, 2024 and will not be adjusted against the cost of raw materials.

In the subsequent year on settlement date, the company would recognize or provide in the Profit and Loss account an exchange gain of ₹ 1 per US dollar, i.e. the difference from balance sheet date to the date of settlement between ₹ 65 and ₹ 64 per US dollar i.e. ₹ 12,000.

Hence, the accounting treatment adopted by Accountant of the company is incorrect.

Question 2 *(Inter May 2018) (5 Marks)* *Pg no.*_____

ABC Ltd. borrowed US $ 5,00,000 on 01/01/2021, which was repaid as on 31/07/2021. ABC Ltd. prepares financial statement ending on 31/03/2021. Rate of Exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/2021 1 US$ = ₹ 68.50 31/03/2021 1 US$ = ₹ 69.50 31/07/2021 1 US$ = ₹ 70.00

You are required to pass necessary journal entries in the books of ABC Ltd. as per AS 11.

Solution

Date	Particulars	Dr.	Cr.
Jan. 01, 2021	Bank A/c (5,00,000*68.50) Dr.	3,42,50,000	
	To Foreign Loan A/c		3,42,50,000
Mar. 31, 2021	Foreign Exchange Difference A/c Dr.	5,00,000	
	To Foreign Loan A/c		5,00,000
	[5,00,000*(69.50-68.50)]		
Mar. 31, 2021	Profit & Loss A/c Dr.	5,00,000	
	To Foreign Exchange Difference A/c		5,00,000
Jul. 31, 2021	Foreign Loan A/c Dr.	3,47,50,000	
	Foreign Exchange Difference A/c Dr.	2,50,000	
	To Bank A/c		3,50,00,000
	Profit & Loss A/c Dr.	2,50,000	
	To Foreign Exchange Difference A/c		2,50,000

Question 3

*Pg no.*_____

Explain briefly the accounting treatment needed in the following cases as per AS 11:

(i) Sundry Debtors include amount receivable from Ted of U.S., ₹ 5,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at $1 = ₹ 38.70.

(ii) Long term loan taken from a U.S. Company, amounting to ₹ 60,00,000. It was recorded at $1 = ₹ 35.60, taking exchange rate prevailing at the date of transactions.

Exchange rates at the end of the year: $1 Receivable = ₹ 45.80 $ 1 Payable = ₹ 45.90

Solution

AS 11 provides that exchange differences attributable to monetary items should be taken to Statement of Profit and Loss. In case option under para 46A is exercised, exchange differences arising on long-term foreign currency monetary items can be adjusted in the cost of depreciable capital asset or in other cases transferred in Foreign Currency Monetary Item Translation Difference A/c (FCMITD) and amortised.

Trade Receivables

Particulars	Foreign currency	Rate	₹
Initial recognition	US $ 12,919.90	38.70	5,00,000
Rate on B/S date		45.80	
Exchange Difference	US $ 12,919.90	7.10	91,731
Gain or loss			Gain
Treatment			Credit to Profit & Loss A/c ₹ 91,731

Long Term loan

Particulars	Foreign currency	Rate	₹
Initial recognition	US $ 1,68,539.33	35.60	60,00,000
Rate on B/S date		45.90	
Exchange Difference	US $ 1,68,539.33	10.30	17,35,955
Gain or loss			Loss
Treatment			Debit to Profit & Loss A/c ₹ 17,35,955 or transfer to FCMITD A/c and amortise.

Question 4 *(Inter Nov 2018) (5 Marks)*

*Pg no.*_____

(i) ABC Ltd. a Indian Company obtained long term loan from WWW private Ltd., a U.S. company amounting to ₹ 30,00,000. It was recorded at US $1 = ₹ 60.00, taking exchange rate prevailing at the date of transaction. The exchange rate on balance sheet date (31.03.2022) was US $1 = ₹ 62.00.

(ii) Trade receivable includes amount receivable from Preksha Ltd., ₹ 10,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = ₹ 59.00. The exchange rate on balance sheet date (31.03.2022) was US $1 = ₹ 62.00.

You are required to calculate the amount of exchange difference and also explain the accounting treatment needed in the above two cases as per AS 11 in the books of ABC Ltd.

Solution

Amount of Exchange difference and its Accounting Treatment

	Long term Loan	Foreign Currency Rate	₹
(i)	Initial recognition US $ 50,000 ₹ (30,00,000/60)	1 US $ = ₹ 60	30,00,000
	Rate on Balance sheet date	1 US $ = ₹ 62	

	Exchange Difference Loss US $ 50,000 x ₹ (62 – 60)		1,00,000
	Treatment: Credit Loan A/c and Debit FCMITD A/c or Profit and Loss A/c by ₹ 1,00,000		
	Trade receivables		
(ii)	Initial recognition US $ 16,949.152* (₹10,00,000/59)	1 US $ = ₹ 59	10,00,000
	Rate on Balance sheet date	1 US $ = ₹ 62	
	Exchange Difference Gain US $ 16,949.152* x ₹ (62-59)		50,847.456*
	Treatment: Credit Profit and Loss A/c by ₹ 50,847.456* and Debit Trade Receivables		

Thus, Exchange Difference on Long term loan amounting ₹ 1,00,000 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on trade receivables amounting ₹ 50,847.456 is required to be transferred to Profit and Loss A/c.

Question 5 *(Inter Jan 2021) (5 Marks)* *Pg no._____*

Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.03.2022

(i) Debtors include amount due from Mr. S ₹ 9,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = ₹ 72.00
US $ 1= ₹ 73.50 on 31st March, 2022
US $ 1= ₹ 72.50 on 1st April, 2021.

(ii) Long term loan taken on 1st April, 2021 from a U.S. company amounting to ₹ 75,00,000. ₹ 5,00,000 was repaid on 31st December, 2021, recorded at US $ 1 = ₹ 70.50. Interest has been paid as and when debited by the US company.
US $1= ₹ 73.50 on 31st March, 2022
US $1=1 ₹ 72.50 on 1st April, 2021

Solution

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

However, at the option of an entity, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a non-depreciable capital asset can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/ liability, by recognition as income or expense in each of such periods.

	Foreign Currency Rate	Amount (₹)
Debtors		
Initial recognition US $12,500 (9,00,000/72)	1 US $ = ₹72	9,00,000
Rate on Balance sheet date	1 US $ = 73.50	
Exchange Difference Gain US $ 12,500 X (73.50 - 72)		18,750
Treatment: Credit Profit and Loss A/c by ₹ 18,750		
Long term Loan		
Initial recognition US $ 1,03,448.28 (75,00,000/72.50)	1 US $ = 72.50	75,00,000
Rate on Balance sheet date	1 US $ = 73.50	

Exchange Difference Loss after adjustment of exchange gain on repayment of ₹ 5,00,000 ₹ 82,171.68 [96,356.08 (US $ 96,356.08 X (₹ 73.5 - ₹ 72.5) less profit 14,184.40 [US $ 7,092.2 (5,00,000/70.5) X ₹ 2)] NET LOSS		82,171.68*
Treatment: Credit Loan A/c and Debit FCMITD A/C or Profit and Loss A/c by ₹ 82,171.68		

Thus, Exchange Difference on Long term loan amounting ₹ 82,171.68 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on debtors amounting ₹ 18,750 is required to be transferred to Profit and Loss A/c.

NOTE 1: *Exchange Difference Loss (net of adjustment of exchange gain on repayment of ₹ 5,00,000) has been calculated in the above solution. Alternative considering otherwise also possible.

NOTE 2: Date of sales transaction of ₹ 9 lakhs has not been given in the question and hence it has been assumed that the transaction took place during the year ended 31 March 2022

Question 6 *(Inter Dec 2021) (5 Marks)* *Pg no.*_____

(i) PP Ltd. an Indian Company acquired long term finance from WW (P) Ltd. a U.S. company, amounting to ₹ 40,88,952. The transaction was recorded at US $1 = ₹ 72.00, taking exchange rate prevailing at the date of transaction. The exchange rate on balance sheet date (31.03.2021) is US $1 = ₹ 73.60.

(ii) Trade receivables of PP Ltd. include amount receivable from Preksha Ltd., ₹ 20,00,150 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = ₹ 73.40. The exchange rate on balance sheet date (31.03.2021) is US $1 = ₹ 73.60. Exchange rate on 1st April, 2020 is US $1 = ₹ 74.00.

You are required to calculate the amount of exchange difference and also explain the accounting treatment needed in the above two cases as per AS 11 in the books of PP Ltd.

Solution

(i) Long term Finance

	Foreign Currency Rate	₹
Initial recognition US $ 56,791 (40,88,952/72)	1 US $ = ₹ 72	40,88,952
Rate on Balance sheet date	1 US $ = ₹ 73.60	
Exchange Difference Loss [US $ 56,791 x (73.60 – 72)]		90,866 (rounded off)

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

However, at the option of an entity, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a non-depreciable capital asset can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/ liability, by recognition as income or expense in each of such periods.

Treatment needed in this case: PP Ltd. can either Debit Foreign Currency Monetary Item Translation Difference (FCMITD) A/c or Debit Profit & Loss A/c by ₹ 90,866 & Credit Loan A/c

(ii) Trade Receivables

	Foreign Currency Rate	₹
Initial recognition US $ 27,250 (20,00,150/ 73.40)	1 US $ = ₹ 73.40	20,00,150
Rate on Balance sheet date	1 US $ = ₹ 73.60	
Exchange Difference Gain [US $ 27,250 X (73.60-73.40)]		5,450

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", exchange differences on trade receivables amounting ₹ 5,450 is required to be transferred to Profit and Loss A/c.
Treatment needed in this case: Credit Profit and loss account by ₹ 5,450.

Question 7

*Pg no.*_____

Opportunity Ltd. purchased an equipment costing ₹ 24,00,000 lakhs on 1.4.2021 and same was fully financed by foreign currency loan (US Dollars) payable in four annual equal installments. Exchange rates were 1 Dollar = ₹ 60.00 and ₹ 62.50 as on 1.4.2021 and 31.3.2022 respectively. First installment was paid on 31.3.2022. The entire difference in foreign exchange has been capitalized. You are required to state that how these transactions would be accounted for.

Solution

As per AS 11, exchange differences arising on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, should be recognized as income or expenses in the period in which they arise. Thus, exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets will be recognized as income or expense.

Calculation of Exchange Difference:

Foreign currency loan = ₹ 24,00,000/60 = 40,000 US Dollars
Exchange difference = 40,000 US Dollars × (62.50-60.00) = ₹ 1,00,000
(including exchange loss on payment of first instalment)
Therefore, entire loss due to exchange differences amounting ₹ 1,00,000 should be charged to profit and loss account for the year.
Note: The above answer has been given on the basis that the company has not availed the option for capitalisation of exchange difference as per para 46/ 46A of AS 11.

However, as per para 46A of the standard, the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset
Accordingly, in case Opportunity Ltd. opts for capitalizing the exchange difference, then the entire amount of exchange difference of ₹ 1,00,000 will be capitalised to 'Equipment account'. This capitalized exchange difference will be depreciated over the useful life of the asset.

Cost of the asset on the reporting date

Initial cost of Equipment	₹ 24,00,000
Add: Exchange difference as on 31.3.2022	₹ 1,00,000
Total cost on the reporting date	₹ 25,00,000

Question 8 *(ICAI Study Material)*

*Pg no.*_____

A Ltd. purchased fixed assets costing ₹3,000 lakhs on 1.1.2021 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 & ₹ 42.50 as on 1.1.2021 & 31.12.2021 respectively. First instalment was paid on 31.12.2021. The entire difference in foreign exchange has been capitalised.
You are required to state, how these transactions would be accounted for.

Solution

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

Calculation of Exchange Difference:

Foreign currency loan = 3,000 lakhs/40 = 75 lakhs US Dollars

Exchange difference = 75 lakhs US Dollars × (42.50 – 40.00) = ₹187.50 lakhs

(including exchange loss on payment of first instalment)

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

Note: The above answer has been given on the basis that the company has not exercised the option of capitalization available under para 46A of AS 11. However, if the company opts to avail the option, then nothing is required to be done since the company has done the correct treatment.

Question 9 *(RTP May 2021)* *Pg no._____*

(a) Classify the following items into Monetary and Non-monetary:
(i) Share capital; (ii) Trade Payables; (iii) Cash balance; (iv) Property, plant and equipment

(b) Trade payables of CAT Ltd. include amount payable to JBB Ltd., ₹ 10,00,000 recorded at the prevailing exchange rate on the date of transaction, transaction recorded at US $1 = ₹ 80.00. The exchange rate on balance sheet date (31.03.2022) was US $1 = ₹ 85.00. You are required to calculate the amount of exchange difference and also explain the accounting treatment needed for this as per AS 11 in the books of CAT Ltd.

Solution

(a) Share capital - Non-monetary; Trade Payables - Monetary
Cash balance – Monetary; Property, plant and equipment - Non-monetary

(b) Amount of Exchange difference and its Accounting Treatment

	Foreign Currency Rate	₹
Trade Payables		
Initial recognition US $ 12,500* (₹10,00,000/80)	1 US $ = ₹ 80	10,00,000
Rate on Balance sheet date	1 US $ = ₹ 85	
Exchange Difference Loss US $ 12,500* x ₹ (85-80)		62,500
Treatment: Debit Profit and Loss A/c by ₹ 62,500		
and Credit Trade Payables		

Thus, Exchange Difference on trade payables amounting ₹ 62,500 is required to be transferred to Profit and Loss

Question 10 *(ICAI Study Material)* *Pg no._____*

Classify the following items into Monetary and Non-monetary:
(i) Inventories; (ii) Trade Receivables; (iii) Investment in Equity Shares; (iv) Property, plant & equipment

Solution

Inventories- Non-monetary; Trade Receivables - Monetary
Investment in Equity Shares – Non-monetary; Property, Plant & Equipment - Non-monetary

Question 11 *(Inter Nov 2023) (5 Marks)* *Pg no._____*

Karna Ltd., an Indian Company, has the following foreign currency transactions during the financial year 2022-23:

(i) On 1st July, 2022, imported goods from Try Ltd., a German based company, amounting to ₹ 30,96,000.

(ii) On 1st October, 2022, imported plant & machinery from Lucy Ltd., a German based company, for € 18,500. The amount was paid on the date of import itself. (Ignore depreciation).

(iii) On 1st December, 2022, exported good on credit to Cream Ltd., a German based company, amounting to ₹ 50,40,000.

All the above transactions were recorded in the books of account at the prevailing exchange rate on the date of the transactions. Ignore taxes and duty on the above transactions. Payment due from Cream Ltd. and payment due to Try Ltd. is outstanding as on 31st March, 2023.

Rate of exchange between reporting currency (₹) and foreign currency (€) on different dates are as under:

On 1st July, 2022	1 € = ₹ 86	On 1st October, 2022	1 € = ₹ 88
On 1st December, 2022	1 € = ₹ 84	On 31st March, 2023	1 € = ₹ 90

You are required, as per AS-11:

a) To show value at which above items will appear in Balance sheet as on 31st March, 2023.

b) To calculate the amount of gain/loss on each of above transactions on account of exchange differences, if any.

Solution

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", Foreign currency monetary items should be reported using the closing rate. Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

i. **Items given in the question will appear in the Balance Sheet at the following values:**
Trade Payables (30,96,000/86= 36,000 German Currency) x ₹ 90 = ₹ 32,40,000
Plant and Machinery 18,500 German Currency X ₹ 88 = ₹16,28,000
Trade Receivables (50,40,000/84= 60,000 German Currency) x ₹ 90 = ₹ 54,00,000

ii. **Amount of gain / loss on each transaction on account of exchange difference:**
Exchange loss on Transaction of import of goods from Try Ltd. = ₹ (1,44,000)
[36,000 German Currency X ₹ 4 (i.e. 90-86)]
Exchange gain on Transaction of export of goods to Cream Ltd = ₹ 3,60,000
[60,000 German Currency X ₹ 6 (i.e. 90-84)]

Question 12 *(Inter Nov 2022) (5 Marks)* *Pg no._____*

a) 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?

b) Trade Payables of Jared Limited includes amount due to Sterling Limited ₹ 9,75,000 recorded at the prevailing exchange rate on 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 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 per AS 11 in the books of Jared Limited.

Solution

(a)

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

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

(b) As per AS 11 "The Effects of Changes in Foreign Exchange Rates", exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be 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 X (79-75)		52,000
Exchange Rate on Settlement date	1 US $ = ₹ 78.30	
Exchange Difference Profit US $ 13,000x(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 x (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.

Question 13 *(RTP May 2018) / (RTP Nov 2019)* *Pg no._____*

Power Track Ltd. purchased a plant for US$ 50,000 on 31st October, 2021 payable after 6 months. The company entered into a forward contract for 6 months @ ₹ 64.25 per Dollar. On 31st October, 2021, the exchange rate was ₹ 61.50 per Dollar. You are required to recognise the profit or loss on forward contract in the books of company for year ended 31st March, 2022

Solution

Calculation of profit or loss to be recognized in the books of Power Track Limited

	₹
Forward contract rate	64.25
Less: Spot rate	(61.50)
Loss/Premium on Contract	2.75
Forward Contract Amount	$50,000
Total loss on entering into forward contract = ($50,000 × ₹ 2.75)	₹ 1,37,500
Contract period	6 months
Loss for the period 1st November, 2021 to 31st March, 2022 i.e. 5 months falling in the year 2021-2022 will be ₹ 1,37,500*5/6 =	₹ 1,14,583

Thus, the loss amounting to ₹ 1,14,583 for the period is to be recognized in the year ended 31st March, 2022.

Question 14 *(Inter Nov 2018) (5 Marks) / (RTP May 2020)* *Pg no._____*

AXE Limited purchased fixed assets costing $ 5,00,000 on 1st Jan. 2021 from an American company M/s M&M Limited. The amount was payable after 6 months. The company entered into a forward contract on 1st January 2021 for five months @ ₹ 62.50 per dollar. The exchange rate per dollar was as follows:

On 1st January, 2021 ₹ 60.75 per dollar On 31st March, 2021 ₹ 63.00 per dollar

You are required to state how the profit or loss on forward contract would be recognized in the books of AXE Limited for the year ending 2020-21, as per the provisions of AS 11.

Solution

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", an enterprise may enter into a forward exchange contract to establish the amount of the reporting currency required, the premium or discount arising at the inception of such a forward exchange contract should be amortized as expenses or income over the life of the contract.

Forward Rate	₹ 62.50
Less: Spot Rate	(₹ 60.75)
Premium on Contract	₹ 1.75
Contract Amount	US$ 5,00,000
Total Loss (5,00,000 x 1.75)	₹ 8,75,000
Contract period 5 months	

3 months falling in the year 2020-21; therefore loss to be recognized in 2020-21 (8,75,000/5) x 3 = ₹ 5,25,000. Rest ₹ 3,50,000 will be recognized in the following year 2021-22.

Question 15 *Pg no._____*

Mr. Y bought a forward contract for three months of US $ 2,00,000 on 1st December 2021 at 1 US $ = ₹ 44.10 when the exchange rate was 1 US $ = ₹ 43.90. On 31-12-2021, when he closed his books, exchange rate was 1 US $ = ₹ 44.20. On 31st January, 2022 he decided to sell the contract at ₹ 44.30 per Dollar. Show how the profits from the contract will be recognized in the books of Mr. Y.

Solution

As per AS 11, in recording a forward exchange contract intended for trading or speculation purpose, the premium or discount on the contract is ignored and at each balance sheet date, the value of contract is marked to its current market value and the gain or loss on the contract is recognised. Since the forward contract was for speculation purposes the premium on forward contract i.e. the difference between the spot rate and the forward contract rate will not be recorded in the books.

Only when the forward contract is sold the difference between the forward contract rate and sale rate will be recorded in the Profit & Loss Account.

	₹
Sale rate	44.30
Less: Contract rate	(44.10)
Profit on sale of contract per US$	00.20

Contract Amount US $ 2,00,000

Total profit (2,00,000 x 0.20) ₹ 40,000

ACCOUNTING FOR GOVERNMENT GRANTS

AS 12

Meaning of Government	Refers to government, government agencies and similar bodies whether local, national or international.	
Meaning of Government Grants	Assistance by Government in cash/kind to an enterprise for past or future compliance with certain conditions	
Other nomenclatures	Subsidies, Cash incentives, duty drawback etc.	
Recognition	When there is a reasonable assurance that ➢ The enterprise will comply with the conditions attached to them and ➢ The grants will be received	
Scope Exclusion	This Standard does not deal with: ➢ Government assistance other than in the form of government grants. ➢ Government participation in the ownership of the enterprise.	
SPECIFIC FIXED ASSETS		
Meaning	Government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such asset. Other conditions may also be attached restricting the type or location of assets or periods during which they are to be acquired or held.	
Method 1	➢ Grant-should be presented in balance sheet by showing it as a **deduction from gross value** of the concerned asset while arriving at its book value. ➢ If the grant amount equals the whole of the fixed asset cost, then the assets should be shown in the balance sheet at a nominal value.	
Method 2	***Related to Depreciable asset***	Should be treated as **deferred income** which should be recognized in the P & L statement on a systematic and rational basis over the useful life of the asset i.e. income is allocated over the period and in the proportions in which depreciation on related assets in charged.
	Related to Non-Depreciable asset	Should be credited to **capital reserve**. However, if a grant related to a non-depreciable asset requires fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income.
REVENUE		
Treatment	❖ Such grants should be recognized in the Statement of P&L on a systematic basis so as to match them with the related cost. ❖ These grants presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. or alternatively, these may be deducted from the related expenses.	

PROMOTER'S CONTRIBUTION	
Meaning	These are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay & no repayment is ordinarily expected in respect thereof.
Example	Central investment subsidy scheme (capital subsidy), investment in backward area etc.
Accounting	Treated as **capital reserve** and treated as part of shareholders funds. These cannot be distributed as dividend, nor considered as deferred income.
NON-MONETARY GRANT	
Assets given at concessional rate	It should be accounted for on the basis of its **acquisition cost**
Assets given free of cost	It should be recorded at a **nominal value**
GRANT RECEIVABLE AS COMPENSATION FOR EXPENSE/LOSS	
Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be recognised and disclosed in the profit and loss statement of the period in which they are receivable, as an **extraordinary item if appropriate**.	
REFUND OF GOVERNMENT GRANTS	
Nature	Government grants sometimes become refundable because certain conditions are not fulfilled & are treated as an **extraordinary item** (AS 5).
Related to Revenue	Applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.
Related to Specific Fixed Asset	Recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.
In the nature of Promoter's Contribution	Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.
DISCLOSURE REQUIREMENTS	
(i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;	
(ii) the nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.	

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no.*_____

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 asset government granted it a grant for ₹ 10 lakhs. Pass the necessary journal entries in the books of the company for first two years if

Case 1: Grant is deducted from the value of fixed asset.

Case 2: Grant is treated as deferred income.

Question 2 *(ICAI Study Material)* *Pg no.*_____

A Ltd. purchased 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 fixed assets, if

(1) the grant is credited to Fixed Assets A/c.

(2) the grant is credited to Deferred Grant A/c.

Question 3 *(ICAI Study Material) / (RTP May 2022) (Similar)* *Pg no.*_____

A fixed asset is purchased for ₹ 20 lakhs. Government grant received towards it is ₹ 8 lakhs. Residual Value is ₹ 4 lakhs and useful life is 4 years. Assume depreciation on the basis of Straight Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of ₹ 5 lakhs due to non compliance with certain conditions. Pass journal entries for first 2 years.

Question 4 *(ICAI Study Material)* *Pg no.*_____

On 1.4.2018 ABC Ltd. received Government grant of ₹ 300 lakhs for acquisition of a machinery costing ₹ 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 2021 due to nonfulfillment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd. assuming that the company did not charge any depreciation for the year 2021?

Question 5 *(RTP May 2019)* *Pg no.*_____

Viva Ltd. received a specific grant of ₹ 30 lakhs for acquiring the plant of ₹ 150 lakhs during 2018-19 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet. During 2021-22, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the Government. Balance in the deferred income on that date was ₹ 21 lakhs and written down value of plant was ₹ 105 lakhs.

(i) What should be the treatment of the refund of the grant and the effect on cost of the fixed asset and the amount of depreciation to be charged during the year 2021-22 in profit and loss account?

(ii) What should be the treatment of the refund, if grant was deducted from the cost of the plant during 2018-19 assuming plant account showed the balance of ₹ 84 lakhs as on 1.4.2021?

Question 6 *(RTP May 2021) / (RTP May 2023) / (ICAI Study Material)* *Pg no.*_____

Hygiene Ltd. had received a grant of ₹ 50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund

the said amount in 2024. The company debited the said amount to its machinery in 2024 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary adjusting entries in the year 2024 to incorporate the retrospective impact of same. State whether treatment done by company is correct or not.

Solution

As per the facts of the case, Hygiene Ltd. had received a grant of ₹ 50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions.

In such circumstances, AS 12, "Accounting for Government Grants", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

Accordingly, the accounting treatment given by Hygiene Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of AS 12.

Question 7 *(ICAI Study Material)* *Pg no._____*

X Ltd. runs a charitable hospital. It incurs salary of doctors, staff etc. to the extent of ₹ 30 lakhs per annum. As a support, the local govt grants a lumpsum payment of ₹ 90 lakhs to meet the salary expense for a period of next 5 years. You are required to pass the necessary journal entries in the books of the company for first year and present in the statement of Profit & loss when the grant is:

a) Shown separately as Other Income; and ;
b) Deducted against the Salary costs.

Question 8 *(ICAI Study Material)* *Pg no._____*

Co X runs a charitable hospital. It incurs salary of doctors, staff etc. to the extent of ₹ 30 lakhs per annum. As a support, the local govt grants a lumpsum payment of ₹ 90 lakhs to meet the salary expense for a period of next 5 years. At the start of Year 4, Co X is unable to meet the conditions attached to the grant and is required to refund the entire grant of 90 lakhs.

You are required to pass the necessary journal entries in the books of the company for refund of the grant if the grant was shown separately as Other Income

Question 9 *(ICAI Study Material)* *Pg no._____*

Supriya Ltd. received grant of ₹ 2,500 lakhs during accounting year 2020-21 from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2021-22, it was found that conditions of grants were not complied with and the grant had to be refunded to the government in full. Elucidate the current accounting treatment, with reference to provisions of AS-12.

Solution

As per AS 12 'Accounting for Government Grants', Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item as per AS 5. The amount refundable in respect

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

In the present case, the amount of refund of government grant should be first adjusted against the unamortised deferred income in the books and the excess if any will be debited to profit & loss account of the company as an extraordinary item in the year 2021-2022.

Question 10 *(ICAI Study Material)* *Pg no._____*

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment, for which no repayment was ordinarily expected. Moreover, there was no condition that the company should purchase any specified assets for this subsidy. Having fulfilled all the conditions under the scheme, the company on its investment of ₹ 50 crore in capital assets received ₹ 10 crore from the Government in January, 2022 (accounting period being 2021-2022). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2022. Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.

Solution

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

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus, it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment desired by the company is not proper.

Question 11 *(ICAI Study Material) / (RTP Nov 2023) (Similar)* *Pg no._____*

Santosh Ltd. has received a grant of ₹ 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed ₹ 2 crores as dividend. Also, Santosh Ltd. received land free of cost from the State Government but it has not recorded it at all in the books as no money has been spent.

In the light of AS 12 examine, whether the treatment of both the grants is correct.

Solution

As per AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. So the grant received for setting up a factory is not available for distribution of dividend.

In the second case, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value.

The treatment of both the elements of the grant is incorrect as per AS 12.

Question 12 *(RTP May 2020) / (RTP Nov 2020) / (ICAI Study Material) (Similar)* *Pg no._____*

How would you treat the following in accounts in accordance with AS-12 'Government Grants'?

a) ₹ 35 Lakhs received from Local Authority for providing medical facilities to employees.

b) ₹ 100 Lakhs received as Subsidy from the Central Government for setting up a unit in a notified backward area. This subsidy is in nature of promoters' contribution.

c) ₹ 10 Lakhs Grant received from the Central Government on installation of antipollution equipment

Solution

a) ₹ 35 lakhs received from the local authority for providing medical facilities to the employees is a grant received in the nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, ₹ 35 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

b) As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of ₹ 100 lakhs should be credited to capital reserve.

c) ₹ 10 lakhs grant received for installation anti-pollution equipment is a grant related to specific fixed asset. Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Thus, ₹ 10 lakhs may either be deducted from the cost of equipment or treated as deferred income to be recognized on a systematic basis in profit & Loss A/c over the useful life of equipment.

Question 13 *(RTP May 2018) / (RTP Nov 2021) (Similar)* *Pg no._____*

D Ltd. acquired a machine on 01-04-2018 for ₹ 20,00,000. The useful life is 5 years. The company had applied on 01-04-2018, for a subsidy to the tune of 80% of the cost. The sanction letter for subsidy was received in November 2021. The Company's Fixed Assets Account for the financial year 2021-22 shows a credit balance as under:

Particulars	₹
Machine (Original Cost)	20,00,000
Less: Accumulated Depreciation (from 2018-19- to 2020-21 on Straight Line Method)	(12,00,000)
	8,00,000
Less: Grant received	(16,00,000)
Balance	(8,00,000)

How should the company deal with this asset in its accounts for 2021-22? Can it charge depreciation or negative depreciation for 2021-22? Can it credit ₹ 8,00,000 to Capital Reserve?

Solution

From the above account, it is inferred that the Company follows Reduction Method for accounting of Government Grants. Accordingly, out of the ₹ 16,00,000 that has been received, ₹ 8,00,000 (being the balance in Machinery A/c) should be credited to the machinery A/c.

The balance ₹ 8,00,000 may be credited to P&L A/c, since already the cost of the asset to the tune of ₹ 12,00,000 had been debited to P&L A/c in the earlier years by way of depreciation charge, and ₹ 8,00,000 transferred to P&L A/c now would be partial recovery of that cost.

There is no need to provide depreciation for 2021-22 or 2022-23 as the depreciable amount is now Nil. In respect of Depreciable Assets, AS-12 does not permit the crediting of the grant or any part thereof to Capital Reserve A/c.

Question 14 *(Inter May 2022) (5 Marks)*

Pg no._____

Suraj Limited provides you the following information:

(i) It received a Government Grant @40% towards acquisition of Machinery worth ₹ 25 Crores.

(ii) It received a Capital Subsidy of ₹ 150 Lakhs from Government for setting up a Plant costing ₹ 300 Lakhs in a notified backward region.

(iii) It received ₹ 50 Lakhs from Government for setting up a project for supply of arsenic free water in a notified area.

(iv) It received ₹ 5 Lakhs from the Local Authority for providing Corona Vaccine free of charge to its employees and their families.

(v) It also received a performance award of ₹ 500 Lakhs from Government with a condition of major renovation in the Power Plant within 3 years. Suraj Limited incurred 90% of amount towards Capital expenditure and balance for Revenue Expenditure.

State, how you will treat the above in the books of Suraj Limited.

Solution

(i) As per AS 12 "Accounting for Govt. Grants", two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under the first alternative, the grant of ₹ 10 crores (40% of 25 crores) is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognized the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Under second alternative, grant amounting ₹ 10 crores is treated as deferred income which is recognized in the profit & loss statement on a systematic and rational basis over the useful life of the asset.

(ii) In the given case, the grant amounting ₹ 150 lakhs received from the Central Government for setting up a plant in notified backward area may be considered as in the nature of promoters' contribution. Thus, amount of ₹ 150 lakhs should be credited to capital reserve and the plant will be shown at ₹ 300 lakhs.

(iii) ₹ 50 lakhs received from Govt. for setting up a project for supply of arsenic free water in notified area should be credited to capital reserve.
Alternatively, if it is assumed that the project consists of capital asset only, then the amount of ₹ 50 lakhs received from Govt. for setting up a project for supply of arsenic free water should either be deducted from cost of asset of the project concerned in the balance sheet or treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(iv) ₹ 5 lakhs received from the local authority for providing corona vaccine to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss account, either separately or under a general heading 'Other Income'. Alternatively, ₹ 5 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

(v) ₹ 500 Lakhs will be reduced from the renovation cost of power plant or will be treated as deferred income irrespective of the expenditure done by the entity out of it as it was specifically received for the purpose major renovation of power plant. However, it may be, later on, decided by the Govt. whether the grant will have to be refunded or not due to non-compliance of conditions attached to the grant.

Question 15 *(RTP Sep 2024)* *Pg no._____*

Energy Ltd. has acquired a generator on 1.4.2023 for ₹ 100 lakh. On 2.4.2023, it applied to Indian Renewal Energy Development Authority (IREDA) for a subsidy. The subsidy was granted in June, 2024 after the accounts for 2023-2024 were finalized. The company has not accounted for the subsidy for the year ended 31.3.2024.

State

(i) Is this a prior period item?

(ii) How should the subsidy be accounted in the accounting year 2024-2025?

Solution

(i) Whether a subsidy applied is to be classified as prior period item as per AS 5, depends upon whether the company has committed an error in 2023-2024 by not recognising the subsidy?

The answer is in para 13 of AS 12 "Accounting for Government Grants" which permits recognition of grant only when there is reasonable assurance that -

(i) the enterprise will comply with the conditions attached to them and

(ii) the subsidy will be received.

Mere making of an application does not provide the reasonable assurance that the subsidy will be received. Letter of sanction from IREDA is required to provide this assurance. Since, the subsidy was granted in June, 2024 after approval of accounts, non-recognition of grant in 2023-2024 will not be considered as an error. Hence, this is not a prior period item. Therefore, the company was right in not recognizing the grant.

Further, AS 4 requires adjustment of events occurring after the balance sheet date only upto the date of approval of accounts by the Board of Directors. In view of this, the company is correct in not adjusting the same in the accounts in the year 2023-2024.

(ii) The subsidy should be deducted from the cost of the generator. The revised unamortised amount of generator should be written off over the remaining useful life.

Alternatively, the same may be treated as 'deferred income' and allocated over the remaining useful life in the proportion in which depreciation is charged.

Question 16 *(ICAI Study Material)* *Pg no._____*

AS 12 deals with recognition and measurement of government grants. Please elaborate the parameters which are required to be met before an entity can recognise government grants in its books?

Solution

A government grant is recognised when there is reasonable assurance that:

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

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

PRACTICE QUESTIONS

Question 1 *(Inter Jan 2021) (5 Marks)* Pg no._____

Darshan Ltd. purchased a Machinery on 1st April, 2018 for ₹ 130 lakhs (Useful life is 4 Years). Government grant received is ₹ 40 lakhs for the purchase of above Machinery. Salvage value at the end of useful life is estimated at ₹ 60 lakhs. Darshan Ltd. decides to treat the grant as deferred income. Calculate the amount of depreciation and grant to be recognized in profit & loss account for the year ending 31st March, 2019, 31st March, 2020, 31st March, 2021 & 31st March, 2022. Darshan Ltd. follows straight line method for charging depreciation.

Solution

As per 12 "Accounting for government grants", grants related to depreciable assets, if treated as deferred income are recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Amount of depreciation & grant to be recognized in the Profit & Loss account each year

Depreciation per year:

	Amount (in Lakhs)
Cost of the Asset	130
Less: Salvage Value	(60)
	70
Depreciation per year (70 Lakhs/4)	17.50

₹ 17.50 Lakhs depreciation will be recognized for the year ending 31st March, 2019, 31st March, 2020, 31st March, 2021 and 31st March, 2022.

Amount of grant recognized in P&L Account each year: 40 lakhs /4 years = ₹ 10 Lakhs for the year ending 31st March, 2019, 31st March, 2020, 31st March, 2021 and 31st March, 2022.

Question 2 *(Inter Nov 2023) (5 Marks)* Pg no._____

A Ltd. purchased a Machinery for ₹ 75 Lakhs. Government Grant received towards this Machinery is ₹ 10 Lakhs. Residual Value of Machinery at the end of useful life of 6 Years is ₹ 5 Lakhs. Asset is shown in Balance Sheet at net of grant. At the beginning of the 3rd year, an amount becomes refundable to the extent of ₹ 8 Lakhs due to non-compliance of certain conditions of grant. You are required to give necessary Journal entries for the 1st year and the 3rd year in the books of A Ltd.

Solution

Journal Entries in the Books of A Ltd.

Year	Particulars		₹ in lakhs (Dr.)	₹ in lakhs (Cr.)
1	Machinery Account	Dr.	75	
	To Bank Account			75
	(Being machinery purchased)			
2	Bank Account	Dr.	10	
	To Machinery Account			10
	(Being grant received from the government reduced from the cost of machinery)			
3	Depreciation Account (W.N.1)	Dr.	10	
	To Machinery Account			10
	(Being depreciation charged on Straight Line method (SLM))			

4	Profit & Loss Account	Dr.	10	
	To Depreciation Account			10
	(Being depreciation transferred to Profit and Loss Account at the end of year 1)			
5	Machinery Account	Dr.	8	
	To Bank Account			8
	(Being government grant on machinery partly refunded which increased the cost of fixed asset)			
6	Depreciation Account (W.N.2)	Dr.	12	
	To Machinery Account			12
	(Being depreciation charged on SLM on revised value of fixed asset prospectively)			
7	Profit & Loss Account	Dr.	12	
	To Depreciation Account			12
	(Being depreciation transferred to Profit and Loss Account at the end of year 3)			

Working Notes:

1. Depreciation for Year 1

	₹ in lakhs
Cost of the Machinery	75
Less: Government grant received	(10)
	65
Depreciation [(65 – 5)/6]	10

2. Depreciation for Year 3

	₹ in lakhs
Cost of the Machinery	75
Less: Government grant received	(10)
	65
Less: Depreciation for the first two years	20
	45
Add: Government grant refundable	8
	53
Depreciation for the third year [(53 – 5)/4]	12

Question 3 *(ICAI Study Material)* *Pg no.*_____

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 (This amount was reduced from the cost of fixed asset). Grant was considered as refundable in the end of 2nd year to the extent of ₹ 7,00,000. Pass the journal entry for refund of the grant as per the first method.

Solution

Year	Particulars	L.F.	Dr.	Cr.
2	Fixed Asset Account Dr.		7,00,000	
	To Bank Account			7,00,000
	(Being grant on asset partly refunded which increased cost of fixed asset)			

Question 4

Pg no._____

Ram Ltd. purchased machinery for ₹ 80 lakhs. (useful life 4 years and residual value ₹ 8 lakhs). Government grant received is ₹ 32 lakhs.
Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets in the third year and the amount of depreciation for remaining two years, if
(i) the grant is credited to Fixed Assets A/c.
(ii) the grant is credited to Deferred Grant A/c

Solution

(i) Grant is credited to Fixed Assets A/c

a) Journal Entry (at the time of refund of grant)

Particulars	L.F.	Dr. (in Lakhs)	Cr. (in Lakhs)
Fixed Asset Account Dr.		32	
To Bank Account			32
(Being government grant refunded)			

b) Value of Fixed Assets after two years but before refund of grant
Fixed assets initially recorded in the books = ₹ 80 lakhs – ₹ 32 lakhs = ₹ 48 lakhs
Depreciation for each year = (₹ 48 lakhs – ₹8 lakhs)/4 years
= ₹ 10 lakhs per year for first two years.
Value of the assets before refund of grant =₹ 48 lakhs - ₹ 20 lakhs = ₹ 28 lakhs

c) Value of Fixed Assets after refund of grant

Value of Fixed Assets before refund of grant	₹ 28 lakhs
Add Refund of grant	₹ 32 lakhs
	₹ 60 lakhs

d) Amount of depreciation for remaining two years
Value of the fixed assets after refund of grant –residual value of the assets / No. of years
= (₹ 60 lakhs - ₹ 8 lakhs) / 2 = ₹ 26 lakhs per annum will be charged for next two years.

(ii) Grant is credited to Deferred Grant A/c

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 assets is charged.

Accordingly, in the first two years (₹ 32 lakhs /4 years) = ₹ 8 lakhs x 2 years = ₹ 16 lakhs will be credited to Profit & Loss A/c and ₹ 16 lakhs will be the balance of Deferred Grant A/c after two years.

a) Journal Entry (at the time of refund of grant)

Particulars	L.F.	Dr. (in Lakhs)	Cr. (in Lakhs)
Deferred Grant A/c Dr.		16	
P&L A/c Dr.		16	
To Bank Account			32
(Being government grant refunded)			

b) Value of Fixed Assets after two years but before refund of grant
Fixed assets initially recorded in the books = ₹ 80 lakhs
Depreciation for each year = (₹ 80 lakhs – ₹8 lakhs)/4 years = ₹ 18 lakhs per year
Book value of fixed assets after 2 years = ₹ 80 lakhs – (₹ 18 lakhs x 2 years) = ₹ 44 lakhs

c) Value of Fixed Assets after refund 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 ₹ 44 lakhs.

d) Amount of depreciation for remaining two years
Depreciation will continue to be charged at ₹ 18 lakhs per annum for the remaining two years

Question 5 *(Inter May 2018) (5 Marks)* *Pg no._____*

On 01.04.2018, XYZ Ltd. received Government grant of ₹ 100 Lakhs for an acquisition of new machinery costing ₹ 500 lakhs. The grant was received and credited to the cost of the assets. The life span of the machinery is 5 years. The machinery is depreciated at 20% on WDV method. The company had to refund the entire grant on 2nd April, 2021 due to non-fulfilment of certain conditions which was imposed by the government at the time of approval of grant. How do you deal with the refund of grant to the Government in the books of XYZ Ltd., as per AS 12?

Solution

According to AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset (if the grant had been credited to the cost of fixed asset at the time of receipt of grant) should be recorded by increasing the book value of the asset, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(in Lakhs)
1st April 2018	Acquisition cost of machinery (500 – 100)	400.00
31st March 2019	Less: Depreciation @ 20%	(80.00)
1st April 2019	Book value	320.00
31st March 2020	Less: Depreciation @ 20%	(64.00)
1st April 2020	Book value	256.00
31st March 2021	Less: Depreciation @ 20%	(51.20)
1st April 2021	Book value	204.80
2nd April 2021	Add: Refund of grant	100.00
	Revised Book value	**304.80**

Depreciation @ 20% on the revised book value amounting ₹ 304.80 lakhs is to be provided prospectively over the residual useful life of the asset.

Question 6 *(Inter Nov 2020) (5 Marks)* *Pg no._____*

On 1st April, 2018, Mac Ltd. received a Government Grant of ₹ 60 lakhs for acquisition of machinery costing ₹ 300 lakhs. The grant was credited to the cost of the asset. The estimated useful life of the machinery is 10 years. The machinery is depreciated @ 10% on WDV basis. The company had to refund the grant in June 2021 due to noncompliance of certain conditions. How the refund of the grant is dealt with in the books of Mac Ltd. assuming that the company did not charge any depreciation for the year 2021-22. Pass necessary Journal Entries for the year 2021-22.

Solution

According to AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset (if the grant had been credited to the cost of fixed asset at the time of receipt of grant) should be recorded by increasing the book value of the asset, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(in Lakhs)
1st April 2018	Acquisition cost of machinery (300 – 60)	240.00
31st March 2019	Less: Depreciation @ 10%	(24.00)
1st April 2019	Book value	216.00
31st March 2020	Less: Depreciation @ 10%	(21.60)
1st April 2020	Book value	194.40
31st March 2021	Less: Depreciation @ 10%	(19.44)

1st April 2021	Book value	174.96
	Less: Depreciation @ 10% for 2 months	(2.916)
1st June 2021	Book value	172.044
June 2021	Add: Refund of grant	60.00
	Revised Book value	**232.044**

Depreciation @ 10% on the revised book value amounting ₹ 232.044 lakhs is to be provided prospectively over the residual useful life of the asset.

**considered refund of grant at beginning of June month and depreciation for two months already charged. Alternative answer considering otherwise also possible.*

Year	Particulars	L.F.	Dr. (in Lakhs)	Cr. (in Lakhs)
2021-22	Machinery Account Dr.		60	
	To Bank Account			60
	(Being government grant on asset refunded which increased cost of fixed asset)			
	Depreciation Account (W.N.) Dr.		19.337	
	To Machinery Account			19.337
	(Being depreciation charged on revised value of fixed asset prospectively for 10 months)			
	Profit & Loss Account Dr.		22.253	
	To Depreciation Account			22.253
	[Being depreciation transferred to Profit and Loss Account at end of year (2.916+19.337)]			

Question 7 *(RTP Nov 2018)* *Pg no._____*

A specific government grant of ₹ 15 lakhs was received by USB Ltd. for acquiring the Hi-Tech Diary plant of ₹ 95 lakhs during the year 2018-19. Plant has useful life of 10 years. The grant received was credited to deferred income in the balance sheet. During 2021-22, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the Government. Balance in the deferred income on that date was ₹ 10.50 lakhs and written down value of plant was ₹ 66.50 lakhs.

(i) What should be the treatment of the refund of the grant and the effect on cost of plant and the amount of depreciation to be charged during the year 2021-22 in P&L Account?

(ii) What should be the treatment of the refund, if grant was deducted from cost of the plant during 2018-19 assuming plant account showed the balance of ₹ 56 lakhs as on 1.4.2021?

You are required to explain in the line with provisions of AS 12.

Solution

As per para 21 of AS 12, 'Accounting for Government Grants', "the amount refundable in respect of a grant related to specific fixed asset should be recorded by reducing the deferred income balance. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

(i) In this case the grant refunded is ₹ 15 lakhs and balance in deferred income is ₹ 10.50 lakhs, ₹ 4.50 lakhs shall be charged to the profit and loss account for the year 2021-22. There will be no effect on the cost of the fixed asset and depreciation charged will be on the same basis as charged in the earlier years.

(ii) If the grant was deducted from the cost of the plant in the year 2018-19 then, para 21 of AS 12 states that the amount refundable in respect of grant which relates to specific fixed assets should be recorded by increasing the book value of the assets, by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Therefore, in this case, the book value of the plant shall be increased by ₹ 15 lakhs. The increased cost of ₹ 15 lakhs of the plant should be amortized over 7 years (residual life). Depreciation charged during the year 2021-22 shall be (56+15)/7 years = ₹ 10.14 lakhs presuming the depreciation is charged on SLM.

Question 8 *(RTP Nov 2019) / (RTP Nov 2022)* *Pg no.*_____

Samrat Limited has set up its business in a designated backward area which entitles the company for subsidy of 25% of the total investment from Government of India. The company has invested ₹ 80 crores in the eligible investments. The company is eligible for the subsidy and has received ₹ 20 crores from the government in February 2022. The company wants to recognize the said subsidy as its income to improve the bottom line of the company.
Do you approve the action of the company in accordance with the Accounting Standard?

Solution

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

The subsidy received by Samrat Ltd. for setting up its business in a designated backward area will be treated as grant by the government in the nature of promoter's contribution as the grant is given with reference to the total investment in an undertaking i.e. subsidy is 25% of the eligible investment and also no repayment is apparently expected in respect thereof.

Since the subsidy received is neither in relation to specific fixed assets nor in relation to revenue. Thus, the company cannot recognize the said subsidy as income in its financial statements in the given case. It should be recognized as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Question 9 *(Inter May 2019) (1 Marks)* *Pg no.*_____

State whether the following statement is 'True' or 'False'. Also give reason for your answer.
As per the provisions of AS-12, government grants in the nature of promoters' contribution which become refundable should be reduced from the capital reserve.

Solution

True: When grants in the nature of promoters' contribution becomes refundable, in part or in full to the government on non-fulfillment of some specified conditions, the relevant amount refundable to the government is reduced from the capital reserve.

Question 10 *Pg no.*_____

Explain in brief treatment of Refund of Government Grants in line with AS 12 in the following situations
a) When Government Grant is related to revenue,
b) When Government Grant is related to specific fixed assets,
c) When Government Grant is in the nature of Promoter's contribution.

Solution

As per AS 12, refund of Government Grant is treated in the following manner:

(a) When Government Grant is related to Revenue:

(i) The amount of refund is first adjusted against any unamortized deferred credit balance still remaining in respect of the Grant.

(ii) Any excess refund over such deferred credit balance or where no deferred credit exists, is immediately charged to Profit & Loss Account.

(b) When Government Grant is related to specific Fixed Asset:

(i) The amount of refund will increase the Book Value of the Asset, if at the time of receipt of Grant, the cost of asset was reduced by the amount of Grant.

(ii) If at the time of receipt, the Grant amount was credited to Deferred Grant Account, then the amount of refund will first reduce the unamortized balance of Deferred Grant Account.

(c) When the Government Grant is in the nature of Promoter's Contribution:

Capital Reserve will be reduced by the amount of refund.

Question 11 *(Inter July 2021) (5 Marks)* *Pg no._____*

Alps Limited has received the following Grants from the Government during the year ended 31st March, 2021:

a) ₹ 120 Lacs received as Subsidy from the Central Government for setting up an Industrial undertaking in Medak, a notified backward area.

b) ₹ 15 Lacs Grant received from the Central Government on installation of Effluent Treatment Plant.

c) ₹ 25 Lacs received from State Government for providing Medical facilities to its workmen during the pandemic.

Advise Alps Limited on the treatment of the above Grants in its books of Account in accordance with AS-12 "Government Grants".

Solution

a) As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outl ay and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up an industrial undertaking in Medak is neither in relation to specific fixed asset nor in relation in revenue. Thus, the amount of ₹ 120 Lacs should be credited to capital reserve.
(Note: Subsidy for setting up an industrial undertaking is considered to be in the nature of promoter's contribution)

b) As per AS 12 'Accounting for Government Grants', 2 methods of presentation in financial statements of grants related to specific fixed assets are regarded as alternatives –

(i) The grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

(ii) Grants related to depreciable asset are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

In the given case, ₹ 15 Lacs was received as grant from the Central Government for installation of Effluent Treatment Plant. Since the grant was received for a fixed asset, either of the above methods can be adopted.

c) ₹ 25 lacs received from State Government for providing medical facilities to its workmen during the pandemic is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as "Other Income". Alternatively, ₹ 25 lacs may be deducted in reporting the related expense i.e., employee benefit expense.

Question 12 *(RTP May 2021)* *Pg no._____*

ABC Ltd. received two acres of land received for set up of plant. It also received ₹ 2 lakhs received for purchase of machinery of ₹ 10 lakhs. Useful life of machinery is 5 years. Depreciation on this machinery is to be charged on straight-line basis. How should ABC Ltd. recognize these government grants in its books of accounts?

Solution

ABC Ltd. should recognize the grants in the following manner:

- As per AS 12, government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value. Accordingly, land should be recognised at nominal value in the balance sheet.
- The standard provides option to treat the grant either as a deduction from the gross value of the asset or to treat it as deferred income as per provisions of the standard. Under first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Accordingly, the grant of ₹ 2 lakhs is deducted from the cost of the machinery. Machinery will be recognised in the books at ₹ 10 lakhs – ₹ 2 lakhs = ₹ 8 lakhs and depreciation will be charged on it as: ₹ 8 lakhs/ 5 years = ₹ 1.60 lakhs per year.

  Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. ₹ 2 lakhs should be recognised as deferred income and will be transferred to profit and loss over the useful life of the asset. In this case, ₹ 40,000 [₹ 2 lakhs / 5 years] should be credited to profit and loss each year over the period of 5 years.

Question 13 *(Inter May 2023) (5 Marks)* *Pg no._____*

On 1st April 2021, Eleanor Limited purchased a manufacturing Plant for ₹ 60 lakhs, which has an estimated useful life of 10 years with a salvage value of ₹ 10 lakhs. On purchase of the Plant, a grant of ₹ 20 lakhs was received from the government.

You are required to calculate the amount of depreciation as per AS-12 for the financial year 2022-23 in the following cases:

(i) If the grant amount is deducted from the value of plant.
(ii) If the grant is treated as deferred income.
(iii) If the grant amount is deducted from the value of Plant, but at the end of year 2022-2023 grant is refunded to the extent of ₹ 4 lakhs, due to non-compliance of certain conditions.
(iv) If the grant is treated as the promoter's contribution.

(Assume depreciation on the basis of Straight-Line Method.)

Solution

Calculation of depreciation as per AS 12 for the financial year 2022-23:

(i) If the grant amount is deducted from the value of Plant, then the amount of deprecation will be ₹ 3,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) / 10 years.

(ii) If the grant is treated as deferred income, then amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000) / 10 years.

(iii) If the grant amount is deducted from the value of plant, but at the end of the year 2022-23 grant is refunded to the extent of ₹ 4 lakh then the amount of depreciation will be ₹ 3,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) /10 year for year 2021-22 and for the year 2022-23 Depreciation will be ₹ 3,00,000 calculated as follows, (₹60,00,000 - ₹ 10,00,000 - ₹ 20,00,000– ₹ 3,00,000) / 9 years.

Note: It is assumed that the depreciation for the year has been charged on the book value on the plant before making adjustment for grant. Alternatively, if it is considered otherwise then the depreciation will be charged after making adjustment for grant. In that case depreciation for the year 2022-23 will be as:

Particulars	₹
Cost of Plant	60,00,000
Less: Salvage	10,00,000
	50,00,000
Less: Grant	20,00,000
	30,00,000
Add: Grant Refundable	4,00,000
	34,00,000
Less: Depreciation for 2021-22	3,00,000
	31,00,000
Useful Life (years)	9
Depreciation for 2022-23	3,44,444

(iv) If the grant is treated as promoter's contribution, then the amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 -10,00,000) /10 years.

Question 14

Pg no._____

An Indian company is engaged by a research company based in USA to carry out research in India, in consideration of billing to be done by Indian company based on cost plus 20% mark up. The Company based in USA paid a sum of ₹ 10 crores to an Indian company to acquire equipment to be used for research. The equipment is owned by the Indian company and a condition is attached in the agreement with the US company that such equipment is to be used for at least 5 years for research work of that company.

How should the amount of ₹ 10 crores be accounted-as capital reserve or as credit to profit and loss account or by credit to the account of the equipment?

Solution

In the given case, the Company has received an amount from a research company in USA to acquire equipment's to be used in research in India which is to be owned by the Indian Company only. The same can be considered as private grant and AS 12 do not apply to private grants. Since the amount received is towards capital items, therefore it is not possible that credit arising out of a grant can be taken to statement of profit and loss. If such grant received is credited to profit and loss, profit or loss position could be easily manipulated through such private grants.

However, in the present case, grant should either be shown as Capital Reserve (not revenue reserves) with proper disclosures or credited to Equipment Account.

EMPLOYEE BENEFITS

AS 15

Objective & Applicability	To prescribe accounting treatment and disclosure for employee benefits in the books of employer except employee share-based payments. The Standard addresses only the accounting of employee benefits by employers. The Standard makes 4 things very clear at the outset: (i) the Standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff); (ii) employee benefits can be paid in cash or in kind; (iii) employee benefits include benefits provided to employees and their dependents (spouses, children and others); and (iv) payment can be made directly to employees, their dependent or to any other party(e.g., legal heirs, nominees, insurance companies, trust etc.)
Basis	The Standard is based on the premise that the costs associated with employees benefits should be matched with the timing of their service. This requires assessment of the anticipated costs and their timing in future and aligning those costs over the period of their service. **Example**: Pension payable to an employee must be recognized as a cost during the service period itself, irrespective of the fact that the pension is payable after the service is completed.
Meaning of Employee	AS 15 does not define who is an 'employee', but states in that "an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel". The ***following indicators*** may suggest an employee relationship may be more likely to exist, and may help in making individual judgements: • A contract of employment exists • Individuals are considered employees for legal/tax/social security purposes • There is a large amount of oversight and direction by the employer and necessary tools, equipment and materials are provided by the employer • Services are performed at a location specified by the employer.
Employer Employee Relationship	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".
Employee Benefits	Employee benefits include: (a) **Short-term employee benefits** (e.g., wages, salaries, paid annual leave & 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)	
Short Term Employee Benefits		
Meaning	These benefits (other than termination benefits) are payable within 12 months after the end of the period in which the service is rendered. Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost.	
Categories	➢ regular period benefits (e.g., wages, salaries) ➢ short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.) ➢ profit sharing and bonuses payable within 12 months after the end of the period in which employee render the related services and ➢ non-monetary benefits (e.g., medical care, housing, cars etc.	
Recognition	➢ The general criteria is that an enterprise should recognize as an expense (unless another AS permits a different treatment) the ***undiscounted amount*** of all short-term employee benefits attributable to services that been already rendered in the period. ➢ Any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate. There are further requirements in respect of short-term compensated absences and profit sharing and bonus plans.	
Short Term Compensated Absences	**Accumulating**	Those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. These may be a) **Vesting**: those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. b) **Non Vesting**: It implies that when employees are not entitled to a cash payment for unused entitlement on leaving. An obligation arises as employees render service that increases their entitlement to future compensated absences.
		➢ The expected cost should be recognized when employees render the service that increase their entitlement to future compensated absences. ➢ 'An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'.

<table>
<tr><td rowspan="2"></td><td></td><td>➢ No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

<u>Example</u>
An enterprise has 100 employees, who are each entitled to five working days of leave for each year. Unused leave may be carried forward for one calendar year. The leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31st December, 2014, the average unused entitlement is two days per employee. The enterprise expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of leave in 2015 and that the remaining eight employees will take an average of six and a half days each.

The enterprise expects that it will pay an additional 12 days of pay as a result of the unused entitlement that has accumulated at 31st December, 2014 (one and a half days each, for eight employees).
Therefore, the enterprise recognises a liability, as at 31st December, 2014, equal to 12 days of pay.</td></tr>
<tr><td>Non Accumulating</td><td>These do not carry forward and are not directly linked to the services rendered by employees in the past (e.g., maternity leave). Therefore, an enterprise recognizes no liability or expense until the time of the absence.
In other words, the cost of non-accumulating absences should be recognized as and when they arise.</td></tr>
<tr><td>Profit Sharing and Bonus Plans</td><td colspan="2">Recognition of expenses for profit sharing and bonus plans would depend on fulfillment of conditions mentioned in the standard. The conditions are:
o Enterprise has a present obligation to make such payments as a result of past events; and
o Reliable estimate of the obligation can be made.
The 2nd condition can be satisfied only when the profit sharing and bonus plans contained a formula for determining the amount of benefit.
The enterprise should recognize the expected cost of profit sharing and bonus payments in the financial statements.

Example
A profit-sharing plan requires an enterprise to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of net profit. The enterprise estimates that staff turnover will reduce the payments to 2.5% of net profit.
The enterprise recognises a liability and an expense of 2.5% of net profit.</td></tr>
</table>

Post Employment Benefits

The accounting treatment and disclosures required for a post-employment benefit plan depend upon whether it is a defined contribution or a defined benefit plan

Defined Contribution Plans (DCP)	These are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. ***Example***: Provident Fund
Defined Benefit Plans (DBP)	These are post-employment benefit plans other than defined contribution plans. In defined benefits plans, the actuarial and investment risk fall on the employer. In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

Is Gratuity Scheme DCP or DBP?

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either:

(a) pay the employee benefits directly when they fall due; or
(b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods

Accounting Treatment	In the Balance Sheet of the enterprise, 'the amount recognized as a defined benefit liability should be the net total of the following amounts: (a) the present value of defined benefit obligation at the balance sheet date (b) minus any past service cost not yet recognized (c) minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.' In case where fair value of plan assets is high, it may so happen that the net amount under defined benefit liability turns negative (giving rise to net assets). AS 15 states that the enterprise, in such a situation, should measure the resulting asset at the lower of: a) the amount so determined; and b) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan The recognition of expenses relating to defined benefits in the Statement of Profit and Loss is stated in Para 61 of the Standard. The Standard identifies seven components of defined employee benefit costs: (a) current service cost; (b) interest cost; (c) the expected return on any plan assets & on any reimbursement rights (d) actuarial gains and losses (to the extent they are recognized); (e) past service cost (to the extent they are recognized); (f) the effect of any curtailments or settlements;* and (g) the extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(b) of the Standard

	*A settlement occurs when an employer enters into a transaction that eliminates all further legal or constructive obligations for part or whole of the benefits provided under a defined benefit plan. ***For example***, the commuted portion of pension. A curtailment occurs when an employer either commits to reduce the number of employees covered by a plan or reduces the benefits under a plan. The gains or losses on the settlement or curtailment of a defined benefit plan should be recognized when the settlement or curtailment occurs.
Actuarial Assumptions	The actuarial assumptions should be unbiased and mutually compatible. They are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. They should be neither imprudent nor excessively conservative and should reflect the economic relationships between factors such as inflation, rates of salary increase, return on plan assets and discount rates. AS 15 explains that actuarial assumptions comprise: (a) ***demographic assumptions*** about the future characteristics of current and former employees (and their dependents) who are eligible for benefits. Demographic assumptions deal with matters such as: • mortality, both during and after employment; • rates of employee turnover, disability and early retirement • the proportion of plan members with dependents who will be eligible for benefits; • claim rates under medical plans; and (b) ***financial assumptions***, dealing with items such as: • the discount rate • future salary and benefit levels • in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments and • the expected rate of return on plan assets
Actuarial Gains and Losses	Actuarial gains and losses comprise: • experience adjustments (the effects of difference between the previous actuarial assumptions and what has actually occurred); and • the effects of changes in actuarial assumptions. Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense.

Other Long Term Employee Benefits

Other long-term employee benefits include, for example:
(a) long-term compensated absences such as long-service or sabbatical leave;
(b) jubilee or other long-service benefits;
(c) long-term disability benefits;
(d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and
(e) deferred compensation paid 12 months or more after end of period in which it is earned

Termination Benefits

Termination Benefits are employee benefits payable as a result of either an enterprise's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept voluntary redundancy in exchange for those benefits (e.g., payments under VRS).

Termination benefits are recognized by an enterprise as a liability and an expense only when the enterprise has

(a) a detailed formal plan for the termination which is duly approved, and

(b) a reliable estimate can be made of the amount of the obligation.

Where the termination benefits fall due within twelve months after the balance sheet date, an undiscounted amount of such benefits should be recognized as liability in the balance sheet with a corresponding charge to Profit & Loss Account. However, when the termination benefits fall due more than 12 months after the balance sheet date, such benefits should be discounted using an appropriate discount rate. Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees expected to accept the offer.

Where there is uncertainty with regard to the number of employees who will accept an offer of voluntary redundancy, a contingent liability exists and should be so disclosed as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no.*_____

Entity XY is required to pay salary of ₹ 2 crore for the year 2021-22. It actually paid a salary of ₹ 1.90 crore up to 31st March 2022, and balance in April 2022. Determine the actual costs to be recognized in the year 2021-22 and any amounts to be shown through balance sheet.

Solution

Total expense for the year (2021-22)	₹ 2 crore
Amount to be shown under liability (unpaid)	₹ 2 crore – 1.90 ₹crore = ₹ 10 lakhs

Question 2 *(ICAI Study Material)* *Pg no.*_____

An employee Roshan has joined a company XYZ Ltd. in the year 2021. 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)

Question 3 *(ICAI Study Material) / (RTP May 2024)* *Pg no.*_____

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

According to AS 15 '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.

Question 4 *(ICAI Study Material)* *Pg no.*_____

The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.2022 calculate the actual return on plan assets:

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.2022	11,40,000
- Fair market value of plan assets as on 31.03.2021	8,00,000

Question 5 *(ICAI Study Material)* *Pg no._____*

As on 1st April, 2021 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 2021 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 2022 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 2021- 2022 were ₹ 600.

On 1st April, 2021, the company made the following estimates, based on its market studies, understanding and prevailing prices.

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

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

Solution

Computation of Expected Returns on Plan Assets as on 31st March, 2022, as per AS 15

	₹
Return on opening value of plan assets of ₹ 1,00,000 (held for the year) @ 10.25%	10,250
Add: Return on net gain of ₹ 30,000 (i.e. ₹ 49,000 – ₹ 19,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets as on 31st March, 2022	11,750

Computation of Actual Returns on Plan Assets as on 31st March, 2022, as per AS 15

	₹	₹
Fair value of Plan Assets as on 31st March, 2022		1,50,000
Less: Fair value of Plan Assets as on 1st April, 2021	1,00,000	
Contribution as on received as 30th September, 2021	49,000	(1,49,000)
		1,000
Add: Benefits paid as on 30th September, 2021		19,000
Actual returns on Plan Assets as on 31st March 2022		**20,000**

Question 6 *(Inter Sep 2024) (5 Marks)* *Pg no._____*

Pendora Ltd. has given the following details in respect of employee benefit pension plan:

Particulars	Amount ₹
The fair value of plan assets as on 01-04-2023	5,00,000
The benefits paid out on 30-11-2023	63,000
Inward contributions received on 30-09-2023	1,42,000
The fair value of plan assets as on 31-03-2024	7,50,000

On 01.04.2023, the company made following estimates, based on its market studies and prevailing prices:

Particulars	%
Interest and dividend income (after tax) payable by fund	10.50
Realised gains on plan assets (after tax)	2.00
Fund administrative costs	-2.00
Expected rate of annual return (Interest is compounded annually)	**10.50**

You are required to find the expected and actual returns on plan assets as on 31.03.2024 as per AS 15.

Solution

Computation of Expected and Actual Returns on Plan Assets

		₹
Return on ₹ 5,00,000 held for 12 months at 10.50%		52,500
Return on ₹ 1,42,000 for 6 months at 10.50%		7,455
Loss of interest on benefits paid for 4 months on ₹ 63,000 @ 10.50%		(2,205)
Expected return on plan assets for 2023-2024		**57,750**
Fair value of plan assets as on 31st March 2024		7,50,000
Less: Fair value of plan assets as on 1 April,2023	5,00,000	
Contributions received on 30.9.2023	1,42,000	(6,42,000)
		1,08,000
Add: Benefits paid on 30th Nov 2023		63,000
Actual return on plan assets		**1,71,000**

Question 7 *(Inter Jan 2025) (4 Marks)* *Pg no.*_____

What is the difference between Defined Contribution Plan and Defined Benefit Plan? From the following information calculate the amount of defined benefit liability / asset:

Particulars	₹ in lakhs
Present Value of Defined Benefit Obligation as on 31-3-2024	36.0
Fair Value of Plan asset	38.5
Past service cost not yet recognized	7.5
Present value of variable future refund from the plan	6.0

Question 8 *(ICAI Study Material)* *Pg no.*_____

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 gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

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

Solution

Gain from curtailment is estimated as under:

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

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

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

Question 9 *(ICAI Study Material)* *Pg no._____*

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:

a. 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.
b. 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

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,

(a) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).
(b) 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.
(c) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

PRACTICE QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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:

i. a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

ii. an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Question 2 *(ICAI Study Material)* *Pg no.*_____

What are the kinds of employees covered in the revised AS 15 and whether a formal employer employee relationship is necessary or not, for benefits to be covered under the Standard?

Solution

The Standard does not define the term "employee". Paragraph 6 of the Standard states that 'an employee may provide services to an enterprise on a full time, part time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The Standard is applicable to all forms of employer employee relationships. There is no requirement for a formal employer employee relationship. Several factors need to be considered to determine the nature of relationship.

Generally, 'outsourcing contracts' may not meet the definition of employer employee relationship. However, such contracts need to be carefully examined to distinguish between a "contract of service" and a "contract for services". A 'contract for services' implies a contract for rendering services, e.g., professional or technical services which is subject to limited direction and control whereas a 'contract of service' implies a relationship of an employer and employee, and the person is obliged to obey orders in the work to be performed and as to its mode and manner of performance.

Question 3 *(ICAI Study Material)* *Pg no.*_____

Whether an enterprise is required to provide for employee benefits arising from informal practices?

Solution

AS 15 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.

Question 4 *(ICAI Study Material)* *Pg no.*_____

In case an enterprise allows unutilised employee benefits, e.g., medical care, leave travel, etc., to be carried forward, whether it is required to recognise a provision in respect of carried forward benefits.

Solution

A provision should be recognised for all benefits (conditional or unconditional) which an employee becomes entitled to as a result of rendering of the service and should be recorded as part of the cost of service rendered during the period in which the service was rendered which resulted the entitlement. In estimating the cost of such benefit the probability of the employee availing such benefit should be considered.

Question 5 *(ICAI Study Material)* *Pg no.*_____

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

As 15 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.

Question 6 *(ICAI Study Material)* *Pg no._____*

The fair value of plan assets of Anupam Ltd. was ₹ 2,00,000 in respect of employee benefit pension plan as on 1st April, 2021. On 30th September, 2021 the plan paid out benefits of ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 2022 the fair value of plan assets was ₹ 3,00,000. On 1st April, 2021 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, 2022, as per AS 15.

Solution

Computation of Expected Returns on Plan Assets as on 31st March, 2022, 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
Expected return on plan assets as on 31st March, 2022	22,000

Computation of Actual Returns on Plan Assets as on 31st March, 2022, as per AS 15

	₹	₹
Fair value of Plan Assets as on 31st March, 2022		3,00,000
Less: Fair value of Plan Assets as on 1st April, 2021	2,00,000	
Contribution as on received as 30th September, 2021	55,000	(2,55,000)
		45,000
Add: Benefits paid as on 30th September, 2021		25,000
Actual returns on Plan Assets as on 31st March 2022		**70,000**

BORROWING COSTS

AS 16

Objective	✓ The objective is accounting for borrowing costs. It does not deal with the actual or imputed cost of owner's equity including preference share capital not classified as liability.
Meaning	✓ These are the **interest and other costs** incurred by an enterprise in connection with the borrowing of funds.
Inclusions	✓ It includes the following: ❖ Interest & related charges on bank borrowings (short term & long term) ❖ amortization of discounts or premiums relating to borrowings ❖ amortization of ancillary costs incurred ❖ finance charges in respect of assets acquired under finance leases ❖ exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

QUALIFYING ASSETS

Meaning	✓ A qualifying asset is an asset (tangible or intangible) that necessarily takes a **substantial period of time** to get ready for its intended use or sale.
Substantial Period	✓ Substantial period of time depends on the facts & circumstances of each case. However, a period of 12 months may be considered a substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case
Inclusions	✓ Following assets take >= 12 months to get ready to use : ❖ Assets that are constructed for own use of enterprise like manufacturing plants, power generation facilities, etc. ❖ Inventories where time is major factor to bring a change in their condition e.g. Liquor & Timber ❖ Investment Properties (Building meant for capital appreciation and earning rental income)
Exclusions	✓ Assets that are ready for intended use when acquired are not qualifying asset.
Examples	

Particulars	Is it a Qualifying Asset?
Property, plant and equipment (PPE)	Yes
Intangible assets	Yes
Investment Properties (Building meant for capital appreciation and earning rental income)	Yes
Inventory	Yes – If they require a substantial period of time to bring them to a saleable condition.
Investments (Financial assets)	No

TREATMENT OF BORROWING COSTS

<table>
<tr><td>Qualifying Asset</td><td>Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.
Treated as directly attributable when such borrowing costs would have been avoided if the expenditure on the qualifying asset have not been made. Determination of such directly attributable amount is an exercise of judgement.</td></tr>
<tr><td>Non Qualifying Asset</td><td>Borrowing cost on any item other than the qualifying asset should be written off in the P&L A/c in the period in which they are incurred.</td></tr>
<tr><td>Specific Borrowing</td><td>To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, amount of borrowing costs eligible for capitalisation
= Actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.</td></tr>
<tr><td>General Borrowing</td><td>To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset.

Capitalisation rate = Borrowing cost on general borrowings / Weighted average of general borrowings o/s during period x 100

<u>Amount eligible for capitalisation:</u>
= Expenditure incurred on Qualifying asset x Capitalisation rate

<u>Note:</u> The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.</td></tr>
<tr><td>Exchange Differences on Foreign Currency Borrowings</td><td>
<table>
<tr><th>Particulars</th><th>Accounting Treatment</th></tr>
<tr><td>Exchange Gain</td><td>Credited to P&L</td></tr>
<tr><td>Exchange Loss</td><td><u>Lower</u> of the following is treated as a part of borrowing costs:
1. Actual exchange loss
2. Interest on local currency borrowings – Interest on foreign currency borrowings.
<u>Note:</u> The excess exchange difference if any will be charged to P&L A/c.</td></tr>
</table>

If there is exchange gain in the next year, then it will reduce the borrowing cost in that year to the extent exchange loss was earlier treated as borrowing cost for that borrowing.</td></tr>
</table>

COMMENCEMENT OF CAPITALISATION

The capitalisation of borrowing costs should commence when **all the following conditions** are satisfied:

- Expenditure for acquisition, construction or production of a qualifying asset is being incurred
- Borrowing costs are being incurred
- Activities that are necessary to prepare the asset for its intended use or sale are in progress

SUSPENSION OF CAPITALISATION

General Rule	✓ Capitalisation of borrowing costs should be suspended during extended periods in which **active development is interrupted**.
Exception	✓ Capitalisation of borrowing costs is not normally suspended during period when substantial technical and administrative work is being carried out. ✓ When a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. **For example**: Capitalisation continues during extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during construction period in the geographic region involved.

CESSATION OF CAPITALISATION

- Capitalisation of borrowing costs should cease when **substantially all the activities** necessary to prepare the qualifying asset for its intended use or sale are **complete**.
- An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete
- **Construction in Parts:** When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities of that part are complete.

DISCLOSURE REQUIREMENTS

The financial statements should disclose:

- the accounting policy adopted for borrowing costs
- the amount of borrowing costs capitalised during the period.

ASSIGNMENT QUESTIONS

Question 1

*Pg no.*_____

X Limited began construction of a new plant on 1st April 2021 and obtained a special loan of 8 lakhs to finance the construction of the plant. The rate of interest on loan was 10 % per annum. The expenditure that was made on the construction project of plant was as follows:

Date	Amount (in ₹)
1st April 2021	10,00,000
1st August 2021	24,00,000
1st January 2022	4,00,000

The Company's other outstanding non - specific loan was ₹ 46,00,000 at an interest of 12% p.a. The construction of the plant was completed on 31-3-2022.
Calculate the amount to be capitalized including amount of interest as per provision of AS 16.

Question 2 *(ICAI Study Material)*

*Pg no.*_____

X Ltd. began construction of a new building on 1st January, 2021. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 2021 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
₹5,00,000	11%
₹9,00,000	13%

The expenditures that were made on the building project were as follows:

Month	Amount (in ₹)
January 2021	2,00,000
April 2021	2,50,000
July 2021	4,50,000
December 2021	1,20,000

Building was completed by 31st December, 2021. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Question 3

*Pg no.*_____

Small Limited began construction of a building on 1st April, 2021 which is expected to cost ₹ 25,00,000. The construction of the building was financed through a special loan of ₹ 5,00,000 obtained at an interest rate of 10% per annum on 1st April, 2021. Further, expenditure on the building was financed through other non-specific finance arrangements of the company. Details of non-specific finance arrangements are as under:

Amount	Rate of Interest
₹ 30,00,000	12% p.a.
₹ 20,00,000	15% p.a.

Cumulative expenses incurred on the building were as follows:

	₹
1st April, 2021	5,00,000
1st July, 2021	13,00,000
1st November, 2021	20,00,000
31st January, 2022	25,00,000

Construction of the building was completed on 31st March, 2022. Following the principles specified in AS 16 'Borrowing Cost', calculate the amount of interest to be capitalized.

Question 4

Pg no._____

ABC Limited has started construction of an asset on 1st December, 2020, which continues till 31st March, 2021 (and is expected to go beyond a year). The entity has not taken any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. The directly attributable expenditure at the beginning of the month on this asset was ₹ 10 lakh in December 2020 and ₹ 4 lakh in each of the months of January to March 2021.

At the beginning of the year, the entity had taken Inter Corporate Deposits of ₹ 20 lakh at 9% rate of interest and had an overdraft of ₹ 4 lakh, which increased to ₹ 8 lakh on 1st March, 2021. Interest was paid on the overdraft at 10% until 1st January, 2021 and then the rate was increased to 12%.

You are required to calculate the annual capitalization rate for computation of borrowing cost in accordance with AS 16 'Borrowing Costs'

Question 5 *(Inter May 2022) (5 Marks)*

Pg no._____

Zebra Limited began construction of a new plant on 1st April,2021 and obtained a special loan of ₹ 20,00,000 to finance the construction of the plant. The rate of interest on loan was 10%. The expenditure that was incurred on the construction of plant was as follows:

	₹
1st April,2021	10,00,000
1st August,2021	24,00,000
1st January,2022	4,00,000

The company's other outstanding non-specific loan was ₹ 46,00,000 at an interest rate of 12%. The construction of the plant completed on 31st March,2022. You are required to:

a) Calculate the amount of interest to be capitalized as per the provisions of AS 16.

b) Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.

Solution

Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

Cost of Plant (10,00,000 + 24,00,000 + 4,00,000)	38,00,000
Add: Amount of interest to be capitalized (W.N.)	3,24,000
	41,24,000

Journal Entry

		₹	₹
31st,	Plant A/c	41,24,000	
March	To Bank A/c		41,24,000
2022	[Being amount of cost of plant and borrowing cost thereon capitalized]		

Working Note:

Computation of interest to be capitalized:

	Expenditure			₹
1st April, 2021	10,00,000	On specific borrowing	₹ 10,00,000 x 10%	1,00,000
1st August, 2021	24,00,000	On specific borrowing	₹ 10,00,000 x 10%	1,00,000
1st August, 2021		On non-specific borrowings	₹ (14,00,000 x 8 x12%)/12	1,12,000

1st January, 2022	4,00,000	On non-specific borrowings	₹ (4,00,000 x 3 x 12%)/12	12,000
				3,24,000

Alternatively, interest cost to be capitalized can be derived by computing average accumulated expenses in the following manner.

Computation of Average Accumulated Expenses:

1st April, 2021	10,00,000 x 12/12	10,00,000
1st August, 2021	10,00,000 x 12/12	10,00,000
	14,00,000 x 8/12	9,33,333
1st January, 2022	4,00,000 x 3/12	1,00,000
		30,33,333

Computation of interest to be capitalized:

		₹
On specific borrowing	₹ 20,00,000 x 10%	2,00,000
On non-specific borrowing	₹ (30,33,333- 20,00,000) x 12%	1,24,000
		3,24,000

NOTE: Since specific borrowings are earmarked for construction of a particular qualifying asset, it cannot be used for construction of any other qualifying asset except for temporary investment. Therefore, once the commencement of capitalization of borrowing cost criteria are met, actual borrowing cost incurred on specific borrowing shall be capitalized irrespective of the fact that amount had been utilized in parts.

Question 6 — *(Inter May 2024) (7 Marks)* — Pg no._____

On 1st April, 2023, Green Limited started the construction of an Office Building (qualified asset). The land under the building is regarded as a separate asset and is not a part of qualifying asset.

For the purpose of construction of building, the company raised a specific loan of ₹ 14 lakhs from a Bank at an interest rate of 12% per annum. An interest income of ₹ 15,000 was earned on this loan while it was held in anticipation of payments.

The company's other outstanding loans on 1st April, 2023 were as follows:

Amount of Loan	Rate of Interest per annum
₹ 20,00,000	15%
₹ 30,00,000	8%

The construction of building started on 1stApril, 2023 and was completed on 31st January, 2024 when it was ready for its intended use. Up to the date of completion of the building, the following payments were made to the contractor:

Payment date	Amount in ₹
1st April, 2023	4,00,000
1st August, 2023	10,00,000
1st December, 2023	25,00,000
31st January, 2024	5,00,000

The life of building is estimated to be 20 years and depreciation is calculated on straight line method.

You are required to:

(i) Calculate the amount of borrowing cost to be capitalized.
(ii) Pass initial journal entry to recognize the cost of building.
(iii) Depreciation on building for the year ending 31st March, 2024.
(iv) Carrying value of building as on 31st March, 2024.

Question 7 *(ICAI Study Material)* *Pg no.*_____

PRM Ltd. obtained a loan for ₹ 120 lakhs on 30th April, 2021. It was utilized as follows:

Particulars	Amount (in ₹ Lakhs)
Construction of a shed	50
Purchase of Machinery	40
Working capital	20
Advance for purchase of Truck	10

Construction of shed was completed in March, 2022. The machinery was installed on the date of its acquisition. Delivery of Truck was not received. Total interest charged by the bank for the year ending 31-03-2022 was 18 Lakhs. Show the treatment of interest.

Question 8 *(RTP May 2020) (Similar)* *Pg no.*_____

Suhana Ltd. issued 12% secured debentures of ₹ 100 Lakhs on 01.05.2021, to be utilized as:

Particulars	Amount (in ₹ Lakhs)
Construction of Factory shed	40
Purchase of Machinery	35
Working capital	25

In March 2022, construction of the factory building was completed and machinery was installed and ready for it's intended use. Total interest on debentures for the financial year ended 31.03.2022 was ₹ 11,00,000. During the year 2021-22, the company had invested idle fund out of money raised from debentures in banks' fixed deposit and had earned an interest of ₹ 2,00,000. Show the treatment of interest under Accounting Standard 16 and also explain nature of assets.

Question 9 *(RTP May 2019)* *Pg no.*_____

M/s. Zen Bridge Construction Limited obtained a loan of ₹ 64 crores to be utilized as under:

S. No.	Particulars	Amount (in ₹)
1.	Construction of Hill link road in Kedarnath:(work was held up totally for a month during the year due to heavy rain which are common in the geographic region involved)	50 crores
2.	Purchase of equipments and machineries	6 crores
3.	Working capital	4 crores
4.	Purchase of vehicles	1 crore
5.	Advance for tools/cranes etc.	1 crore
6.	Purchase of technical know-how	2 crores
7.	Total interest charged by bank for year ending 31st March, 2022	1.60 crores

Show the treatment of interest according to Accounting Standard by M/s. Zen Bridge Construction Limited.

Question 10 *(ICAI Study Material)* *Pg no.*_____

The company has obtained Institutional Term Loan of ₹ 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 2022 amounted to ₹ 406 lakhs, ₹ 58 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of ₹ 52.20 lakhs incurred during 2021-2022 on the entire Institutional Term Loan of ₹ 580 lakhs.

Solution

As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred. A qualifying asset is an asset that necessary takes a substantial period of time to get ready for its intended use or sale. The treatment for total interest amount of ₹ 52.20 lakhs can be given as:

Particulars	Whether Qualifying Asset	Interest to be capitalized	Interest to be charged to P&L A/c
Modernisation and renovation of plant and machinery	Yes	52.20*406/580 = 36.54	
Advance to supplies for additional assets	Yes	52.20*58/580 = 5.22	
Working capital	No		52.20*116/580 = 10.44
		41.76	**10.44**

* It is assumed in the above solution that the modernisation and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assets. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assets on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, ₹ 52.20 lakhs will be recognised as expense in the profit and loss account for year ended 31st March, 2022.

Question 11 *(RTP Nov 2020) (Similar) / (ICAI Study Material)* *Pg no._____*

Rainbow Limited borrowed an amount of ₹ 150 crores on 1.4.2021 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized ₹ 19.50 crores for the accounting period ending on 31.3.2022. Due to surplus fund out of ₹ 150 crores, income of ₹ 3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.

Solution

Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings."

The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. Hence, in the above case, treatment of accountant of Rainbow Ltd. is incorrect. The amount of borrowing costs capitalized for the financial year 2021-2022 should be calculated as follows

	₹ in crores
Actual Interest for 2021-22 (11% of 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 2021-22	13.00

Question 12 *(RTP Sep 2024)* *Pg no._____*

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

	Plan (₹)	Actual (₹)
October, 2023	5,00,000	4,00,000
November, 2023	6,50,000	7,95,000
December, 2023	20,00,000	-
January, 2024	2,00,000	50,000
February, 2024	9,00,000	2,00,000
March, 2024	10,00,000	12,00,000

The company pays to its bank interest at a rate of 15% p.a., which is debited on a monthly basis. During the half year, company had ₹ 20 lakh overdraft up to 31st December, surplus cash in January and again overdraft of ₹ 14 lakh from 1.2.2024 and ₹ 30 lakh from 1.3.2024. The company had a strike during December and hence could not continue the work during said period. However, the substantial administrative work related to the project was continued. Onsite work was again commenced on 1st January and all the work were completed on 31st March. Assume that expenditure was incurred on 1st day of each month.

Calculate interest to be capitalized giving reason wherever necessary. Assume overdraft will be less, if there is no capital expenditure.

Solution

Loyal Ltd.

Month	Actual Expenditure (₹)	Interest on outstanding amount @ 15% p.a.	Interest capitalized (₹)	Outstanding amount	Cumulative amount (₹)
	1		2	3	
October, 2023	4,00,000	4,00,000*15% *1/12	5,000	4,05,000	4,05,000
November, 2023	7,95,000	(4,05,000 +7,95,000) *15%*1/12	15,000	(4,05,000+7,95,000 +15,000)	12,15,000
December, 2023	-	(12,15,000) *15%*1/12	15,188	12,15,000+15,188	12,30,188
January, 2024	50,000		-	12,30,188+50,000	12,80,188
February, 2024	2,00,000	14,00,000 *15%*1/12	17,500	12,80,188+2,00,000 +17,500	14,97,688
March, 2024	12,00,000	(14,97,688+12,00,000) *15 %*1/12	33,721	14,97,688 + 12,00,000+33,721	27,31,409
	26,45,000		**86,409**		

Note:

1. As per para 18 of AS 16, 'Borrowing Cost', capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Therefore, the interest for that period i.e. for the month of December has also been capitalized.
2. During January, company did not incur any interest as there was surplus cash in January. Therefore, no amount should be capitalized during January as per para 14(b) of AS 16.
3. During February, actual overdraft (borrowings) was ₹ 14 lakh only. Hence, interest of ₹ 17,500 on ₹ 14,00,000 has been calculated even though actual expenditure on project exceed ₹ 14 lakh.

Question 13 *(ICAI Study Material)* *Pg no._____*

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2021-22. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹ 50 lakhs.
As on 31st March, 2022, since the said project was not complete, the directors of Take Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment

Solution

As per AS 13, 'Accounting for Investments', the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.
Further, as per AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 2022.

Question 14 *(RTP Nov 2022) / (ICAI Study Material)* *Pg no._____*

Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the building will be started as soon as they are completed.
Following is the detail of the work done on different phases of the building during the current year:

(₹ in lakhs)

	Phase I	Phase II	Phase III	Phase IV
Cash expenditure	10	30	25	30
Building purchased	24	34	30	38
Total expenditure	34	64	55	68
Total expenditure of all phases				221
Loan taken @ 15% at the beginning of the year				200

During mid of the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year.

Solution

	Particulars	₹
1.	Interest expense on loan ₹ 2,00,00,000 at 15%	30,00,000
2	Total cost of Phases I and II (₹ 34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (₹ 55,00,000 + ₹ 68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate Loan amount = (30,00,000*98,00,000)/2,21,00,000 =	13,30,317 (approx.)
7.	Interest on loan used for Phases III & IV, based on proportionate Loan amount	16,69,683 (approx.)

Accounting Treatment:

1. **For Phase I and Phase II**
   Since Phase I and Phase II have become operational at the mid of the year, half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be expensed during the year.
2. **For Phase III and Phase IV**
   Interest of ₹ 16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

Question 15 *(RTP Jan 2025)* *Pg no._____*

How will interest be capitalized when qualifying assets are funded by borrowings in the nature of bonds that are issued at a discount?
X Ltd. issued in year 1, a 3 year 10% p.a. (interest paid annually) bond with a face value of ₹ 1,00,000 at a price of ₹ 90,000 to finance a qualifying asset which is ready for intended use at the end of year 2. Compute the amount of borrowings costs to be capitalized if the company uses for amortization of discount straight line basis.

Solution

As per AS 16, "Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds". Further, as per standard, "amortization of discounts or premiums relating to borrowings" as a component of borrowing costs. Thus, the borrowing costs comprise the periodic interest payable on the bonds in question and the amount of discount amortised during the period.
Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
Thus, only that portion of the amortised discount should be capitalised as part of the cost of a qualifying asset which relates to the period during which acquisition, construction or production of the asset takes place.

Straight line basis **(Amount in ₹)**

Years	Interest	Amortisation of discount	Total borrowing costs
Year 1	10,000	3,333	13,333
Year 2	10,000	3,333	13,333
Year 3	10,000	3,334	13,334

In the above case, the amount of borrowing costs capitalized would be ₹ 13,333 in Year 1 and Year 2. The borrowing costs of ₹ 13,334 incurred in Year 3 would be expensed since the asset is ready for its intended use at the end of Year 2.

Question 16 *(RTP Nov 2023)* *Pg no._____*

Raj & Co. has taken a loan of US$ 20,000 at the beginning of the financial year for a specific project at an interest rate of 6% per annum, payable annually. On the day of taking loan, the exchange rate between currencies was ₹ 48 per 1 US$. The exchange rate at the closing of the financial year was ₹ 50 per 1 US$. The corresponding amount could have been borrowed by the company in Indian Rupee at an interest rate of 11 % per annum.
Determine the treatment of borrowing cost in the books of accounts.

PRACTICE QUESTIONS

Question 1

*Pg no.*_____

G Ltd. began construction of a new building on 1st January, 2021. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 2021 at an interest rate of 11%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
₹ 3,00,000	12%
₹ 7,00,000	14%

The expenditures that were made on the building project were as follows

	₹
January 2021	1,60,000
May 2021	2,70,000
August 2021	4,20,000
December 2021	1,50,000

Building was completed by 31st December, 2021. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Solution

Computation of average accumulated expenses

1,60,000 x 12 / 12	1,60,000
2,70,000 x 8/ 12	1,80,000
4,20,000 x 5 / 12	1,75,000
1,50,000 x 1 / 12	12,500
	5,27,500

Calculation of average interest rate other than for specific borrowings

Amount of loan	Rate of Interest	Amount of interest
3,00,000	12%	36,000
7,00,000	14%	98,000
10,00,000		**1,34,000**
Weighted average rate of interest {(1,34,000/ 10,00,000) x 100}		**13.40%**

Interest on average accumulated expenses

Specific borrowings (₹ 1,00,000 x 11%)	11,000
Non-specific borrowings (₹ 4,27,500* x 13.40%)	57,285
Amount of interest to be capitalized	68,285

*(₹ 5,27,500 – ₹ 1,00,000)

Total expenses to be capitalized for building

Cost of building ₹(1,60,000+2,70,000+4,20,000+1,50,000)	10,00,000
Add: Amount of interest to be capitalized	68,285
	10,68,285

Journal Entry

Date	Particulars	L.F.	Dr.	Cr.
31.12.2021	Building account Dr.		10,68,285	
	To Bank account			10,68,285
	(Being amount of cost of building and borrowing cost thereon capitalized)			

Question 2 *(Inter May 2019) (5 Marks)* *Pg no._____*

First Ltd. began construction of a new factory building on 1st April, 2021. It obtained ₹ 2,00,000 as a special loan to finance the construction of the factory building on 1st April, 2021 at an interest rate of 8% per annum. Further, expenditure on construction of the factory building was financed through other non-specific loans.

Details of other outstanding non-specific loans were:

Amount	Rate of Interest p.a.
4,00,000	9%
5,00,000	12%
3,00,000	14%

The expenditures that were made on the factory building construction were as follows:

Date	Amount
1st April, 2021	3,00,000
31st May, 2021	2,40,000
1st August, 2021	4,00,000
31st December, 2021	3,60,000

The construction of factory building was completed by 31st March, 2022.

As per the provisions of AS 16, you are required to:

(1) Calculate the amount of interest to be capitalized.

(2) Pass Journal entry for capitalizing cost & borrowing cost in respect of factory building

Solution

Computation of average accumulated expenses

3,00,000 x 12 / 12	3,00,000
2,40,000 x 10/ 12	2,00,000
4,00,000 x 8 / 12	2,66,667
3,60,000 x 3 / 12	90,000
	8,56,667

Calculation of average interest rate other than for specific borrowings

Amount of loan	Rate of Interest	Amount of interest
4,00,000	9%	36,000
5,00,000	12%	60,000
3,00,000	14%	42,000
12,00,000		**1,38,000**
Weighted average rate of interest {(1,38,000/ 12,00,000) x 100}		**11.50%**

Interest on average accumulated expenses

Specific borrowings (₹ 2,00,000 x 8%)	16,000
Non-specific borrowings (₹ 6,56,667* x 11.50%)	75,517
Amount of interest to be capitalized	91,517

*(₹ 8,56,667 – ₹ 2,00,000)

Total expenses to be capitalized for building

Cost of building ₹(3,00,000+2,40,000+4,00,000+3,60,000)	13,00,000
Add: Amount of interest to be capitalized	91,517
	13,91,517

Journal Entry

Date	Particulars	L.F.	Dr.	Cr.
31.03.2022	Building account Dr.		13,91,517	
	To Building WIP A/c*			13,00,000
	To Borrowing Costs A/c			91,517
	(Being amount of cost of building and borrowing cost thereon capitalized)			

*Considering that ₹ 13,00,000 was debited to Building WIP A/c earlier.

Question 3 – *(RTP May 2024)* *Pg no._____*

H Ltd. began the construction of a new building on 1st April 2022. It obtained a special loan of ₹ 6,00,000 on 1st April 2022 at an interest of 12% to finance the construction of the building. The company's other outstanding two non-specific loans on 1st April, 2022 were as follows:

Amount in ₹	Rate of Interest
30,00,000	14%
54,00,000	16%

The expenditure incurred on the building project was as per detail given below:

	Amount in ₹
1st May, 2022	12,00,000
1st July, 2022	15,00,000
1st October, 2022	27,00,000
1st March, 2023	7,20,000

The building was completed by 31st March 2023.

Following the provisions of Accounting Standard 16, you are required to calculate the amount of interest to be capitalized and also give one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Solution

Interest amount to be capitalized

		₹
Specific borrowings (₹ 6,00,000 x 12%)	=	72,000
Non-specific borrowings [₹ 30,35,000 (₹ 36,35,000 – ₹ 6,00,000) x 15.29%*]	=	4,64,052
Amount of interest to be capitalized	=	**5,36,052**

Journal Entry for capitalizing cost and borrowing cost

Date	Particulars		Dr. (₹)	Cr. (₹)
31.3.2023	Building account (₹ 61,20,000 + ₹ 5,36,052)	Dr.	66,56,052	
	To Bank account			66,56,052
	(Being amount of cost of building and borrowing cost thereon capitalized)			

Working notes:

(i) Computation of average accumulated expenses

		₹
₹ 12,00,000 x 11 / 12	=	11,00,000
₹ 15,00,000 x 9 / 12	=	11,25,000
₹ 27,00,000 x 6 / 12	=	13,50,000
₹ 7,20,000 x 1 / 12	=	60,000
61,20,000		**36,35,000**

(ii) Calculation of average interest rate other than for specific borrowings

Amount of loan (₹)	Rate of interest		Amount of interest (₹)
30,00,000	14%	=	4,20,000
54,00,000	16%	=	8,64,000
84,00,000			12,84,000
Weighted average rate of interest $\left(\frac{12,84,000}{84,00,000} \times 100\right)$		=	15.29%* (Rounded off)

Question 4 – *(Inter May 2023) (5 Marks)* *Pg no.*_____

On 1st April, 2022 Workhouse Limited took a loan from a Financial Institution for ₹ 25,00,000 for the construction of Building. The rate of interest is 12%.

In addition to above loan, the company has taken multiple borrowings as follows:

(a) 8% Debentures ₹ 15,00,000
(b) 15% Term Loan ₹ 30,00,000
(c) 10% Other Loans ₹ 18,00,000

The company has utilised the above funds in construction/purchase of the following assets:

(a) Building ₹ 70,00,000
(b) Furniture ₹ 22,00,000
(c) Plant & Machinery ₹ 90,00,000
(d) Factory Shed ₹ 43,00,000

The construction of Building, Plant & Machinery and Factory Shed was completed on 31st March 2023. Readymade Furniture was purchased directly from the market. The factory was ready for production on 1 April 2023.

You are required to calculate the borrowing cost for both qualifying and non-qualifying assets.

Solution

Interest to be Capitalized (on qualifying asset)

	Particulars	Computation	₹
i.	On specific Borrowings	25,00,000x12%	3,00,000
ii.	On non-specific borrowings	(W.N.1)	6,67,500
iii.	Amount of interest to be Capitalised	(i+ii)	9,67,500

Interest transferred to P&L (on non-qualifying asset)

	Particulars	Computation	₹
i.	On non-specific Borrowings	(W.N.1)	82,500

Working note:

1. Treatment of interest under AS 16 on non-specific borrowings

	Particulars	Qualifying asset	# Computation	Interest- Capitalized	Interest- charged to P&L A/c
i.	Building	Yes	45,00,000/2,00,00,000 x 63,00,000 x 11.9048%	1,68,750	-
ii.	Furniture	No	22,00,000/2,00,00,000 x 63,00,000 x 11.9048%	-	82,500
iii.	Plant & Machinery	Yes	90,00,000/2,00,00,000 x 63,00,000 x 11.9048%	3,37,500	-
iv.	Factory shed	Yes	43,00,000/2,00,00,000 x 63,00,000 x 11.9048%	1,61,250	-
	Total			**6,67,500**	**82,500**

Note: Alternative manner of presentation for Treatment of interest under AS 16 on non-specific borrowings:

	Particulars	Qualifying asset	Expenses Incurred ₹	Share in borrowings ₹	Interest-Capitalized ₹	Interest-charged to P&L A/c ₹
i.	Building	Yes	45,00,000	7,50,000 x 45/200	1,68,750	-
ii.	Furniture	No	22,00,000	7,50,000 x 22/200	-	82,500
iii.	Plant & Machinery	Yes	90,00,000	7,50,000 x 90/200	3,37,500	-
iv.	Factory shed	Yes	43,00,000	7,50,000 x 43/200	1,61,250	-
	Total		**2,00,00,000**		**6,67,500**	**82,500**

2. Weighted Average interest rate for non-specific borrowings

Particulars	Amount of loan (a)	Rate of interest (b)	Amount of interest (c) = (a) x (b)
Debentures	15,00,000	8%	1,20,000
Term loan	30,00,000	15%	4,50,000
Other loans	18,00,000	10%	1,80,000
	63,00,000		7,50,000
	# Weighted Average Rate of Interest = 7,50,000 / 63,00,000 x 100 = 11.9048%		

Question 5 *(Inter Nov 2023) (5 Marks)* *Pg no.*_____

Glen Ltd. began construction of a new building on 1st January, 2022.

On 1st April, 2022, following two loans were obtained to fund the construction cost:

(i) Loan of ₹ 60,00,000 from Data Bank Ltd. was taken at interest rate of 8% per annum. This loan was fully utilized for construction of the new building.

(ii) Loan of ₹ 20,00,000 from Satya Bank Ltd. Out of this, loan amount of ₹ 6,00,000 was utilized for working capital purpose. Total interest of ₹ 1,92,000 were paid to Satya Bank Ltd. for the financial year 2022-23.

Construction of the new building was completed on 31st January, 2023 and was ready for its intended use on the same date. None of the loan was repaid during the year. The building is a qualifying asset for the purpose of AS-16. Out of loan from Data Bank Ltd., surplus funds were temporarily invested for the short period of time. This temporary investment earned interest of ₹ 30,000.

You are required to calculate the amount of interest (a) to be capitalized, (b) to be charged to profit and loss account from the total interest incurred as borrowing cost during the year 2022-23. (as per AS-16).

Solution

According to AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The standard also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost on Loan of data bank to be capitalized:
= ₹(60,00,000 x 8%)x 10/12 – ₹30,000
= ₹4,00,000 – ₹ 30,000 = ₹3,70,000

Loan	Particulars	Nature of assets	(a) Interest to be Capitalized (₹)	(b) Interest to be charged to Profit & Loss Account (₹)
Data bank	Construction of factory building	Qualifying Asset	3,70,000	(4,80,000 – 4,00,000) 80,000
Satya Bank	Construction of factory building	Qualifying Asset	(1,92,000x14/20) x 10/12 = 1,12,000	(1,92,000 x 14/20) x 2/12 = 22,400
Satya Bank	Working Capital	Not a Qualifying Asset	NIL	(1,92,000x6/20) = ₹57,600
	Total		**₹4,82,000**	**₹1,60,000**

Note: Loan from Satya bank is considered to be specific borrowings.

Question 6 *(RTP May 2023) / (ICAI Study Material)* *Pg no._____*

Expert Limited issued 12% secured debentures of ₹ 100 lakhs on 01.06.2021. Money raised from debentures to be utilized as under:

Intended Purpose	Amount (₹ in lakhs)
Construction of factory building	40
Purchase of Machinery	15
Working Capital	30
Purchase of Furniture	2
Purchase of Truck	13

Additional Information:
(i) Interest on debentures for the Financial Year 2021-2022 was paid by the Company.
(ii) During the year, the company invested idle fund of ₹ 5 lakhs (out of the money raised from debentures) in Bank's fixed deposit and earned interest of ₹ 50,000.
(iii) In March, 2022 construction of factory building was not completed (it is expected that it will take another 6 months).
(iv) In March 2022, Machinery was installed and ready for its intended use.
(v) Furniture was put to use at the end of March 2022.
(vi) Truck is going to be received in April, 2022.
You are required to show the treatment of interest as per AS 16 in respect of borrowing cost for the year ended 31st March, 2022 in the Books of Expert Limited.

Solution

According to AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use. As per the Standard, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognized as an expense in the period in which they are incurred. It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.
Thus, eligible borrowing cost = ₹ 10,00,000 (100 lakhs x 12% x 10/12) – ₹ 50,000 = ₹ 9,50,000

Particulars	Nature of assets	Interest to be Capitalized	Interest to be charged to P&L A/c
Construction of factory building	Qualifying Asset	9,50,000x40/100 = 3,80,000	Nil
Purchase of Machinery	Not a Qualifying Asset	Nil	9,50,000x15/100 = 1,42,500
Working Capital	Not a Qualifying Asset	Nil	9,50,000x30/100 = 2,85,000
Purchase of Furniture	Not a Qualifying Asset	Nil	9,50,000x2/100 = 19,000
Purchase of Truck	Not a Qualifying Asset	Nil	9,50,000x13/100 = 1,23,500
		3,80,000	**5,70,000**

Question 7 *(Inter Nov 2020) (5 Marks)* *Pg no._____*

On 15th April, 2021 RBM Ltd. obtained a Term Loan from the Bank for ₹ 320 lakhs to be utilized as under:

	₹ (in lakhs)
Construction for factory shed	240
Purchase of Machinery	30
Working capital	24
Purchase of Vehicles	12
Advance for tools/cranes etc.	8
Purchase of technical know how	6

In March, 2022 construction of shed was completed & machinery was installed. Total interest charged by the bank for the year ending 31st March, 2022 was ₹ 40 lakhs. In the context of provisions of AS 16, show the treatment of interest and also explain the nature of Assets

Solution

Construction of factory shed amounting ₹ 240 lakhs is qualifying asset in the given case. The interest for this amount during the year will be added to the cost of factory shed. All others (purchase of machinery, vehicles and technical know how, working capital, advance for tools/cranes) are non-qualifying assets & related borrowing cost will be charged to P&L A/c.
Qualifying Asset as per AS 16 (construction of a shed) = ₹ 240 lakhs
Borrowing cost to be capitalized = ₹ 40 lakhs x 240/320 = ₹ 30 lakhs
Interest to be debited to Profit or Loss account: ₹ (40 – 30) = ₹ 10 lakhs.
Note: Assumed that construction of factory shed completed on 31st March, 2022.

Question 8 *(ICAI Study Material)* *Pg no._____*

On 1st April, 2021, Amazing Construction Ltd. obtained a loan of ₹ 32 crores to be utilized as:-

S. No.	Particulars	Amount (in ₹)
1.	Construction of sealink across two cities:(work was held up totally for a month during the year due to high water levels)	25 crores
2.	Purchase of equipments and machineries	3 crores
3.	Working capital	2 crores
4.	Purchase of vehicles	50 Lakhs
5.	Advance for tools/cranes etc	50 Lakhs
6.	Purchase of technical know-how	1 crore
7.	Total interest charged by bank for year ending 31st March, 2022	80 Lakhs

Show the treatment of interest by Amazing Construction Ltd.

Solution

Treatment of Interest (Borrowing cost) as per AS 16 'Borrowing Costs'

Particulars	Whether Q.A.	Interest to be capitalized	Interest to be charged to P&L A/c
Construction of sealink across 2 cities	Yes	80,00,000*25/32= 62,50,000	
Purchase of equipments & machineries	No		80,00,000*3/32= 7,50,000
Working capital	No		80,00,000*2/32= 5,00,000
Purchase of vehicles	No		80,00,000*0.5/32= 1,25,000
Advance for tools/cranes etc	No		80,00,000*0.5/32= 1,25,000
Purchase of technical know-how	No		80,00,000*1/32= 2,50,000
		62,50,000	**17,50,000**

Notes:

As per AS 16, assets have been defined as 'qualifying asset' and 'non-qualifying asset'.

a) Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale; whereas,

b) Non-qualifying asset is an asset which is ready for its intended use or sale at the time of its acquisition.

c) As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets should be capitalized as part of the cost of that asset. Other borrowing costs are recognized as expense in the period in which they are incurred.

d) It is assumed that work held up for a month due to high water level is normal during the construction of sealink and capitalization of borrowing cost should not be suspended for necessary temporary delay.

Question 9 *(RTP May 2018) / (RTP Nov 2019) / (RTP Nov 2021)* *Pg no._____*

In May, 2021, Capacity Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2022 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was ₹ 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2022 amounted to ₹ 25 lakhs.

Can ₹ 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building? Explain the treatment in line with the provisions of AS 16.

Solution

According to AS 16 'Borrowing Costs', capitalisation of borrowing costs should cease when substantially all the activities to prepare the qualifying asset for its intended use or sale are completed.

In the given case, since the qualifying asset was ready to use in January, 2022, therefore, interest till that date can only be capitalized. Hence, interest of ₹ 18 lakhs will only be capitalized. The balance of ₹ 7 lakhs (i.e. 25-18) will be debited to Profit and Loss Account.

Question 10

Pg no._____

A company capitalizes interest cost of holding investments and adds to cost of investment every year, thereby understating interest cost in profit and loss account. Comment on the accounting treatment done by the company in context of the relevant AS.

Solution

Investments other than investment properties are not qualifying assets as per AS-16 Borrowing Costs. Therefore, interest cost of holding such investments cannot be capitalized. Further, even interest in respect of investment properties can only be capitalized if such properties meet the definition of qualifying asset, namely, that it necessarily takes a substantial period of time to get ready for its intended use or sale. Also, where the investment properties meet the definition of 'qualifying asset', for the capitalization of borrowing costs, the other requirements of the standard such as that borrowing costs should be directly attributable to the acquisition or construction of the investment property and suspension of capitalization have to be complied with.

Question 11 *(RTP May 2022)*

Pg no._____

Should capitalization of borrowing costs be continued when the qualifying asset has been constructed but marketing activities to sell the asset are still in progress?

Solution

As per provisions of AS 16, capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Further, the standard also explains that "An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might sill continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete". The emphasis in the Standard is on "to prepare the qualifying asset for its intended use or sale" and not the actual activity of sale. Therefore, where the physical construction of the asset is complete, substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Therefore, in the given case, the borrowing costs pertaining to the period during which the marketing activities to sell the asset are still in progress should not be capitalized as part of the cost of the asset.

Question 12 *(ICAI Study Material)*

Pg no._____

H Ltd. incurs borrowing costs for the purpose of construction of a qualifying asset for its own use. The construction gets completed on May 31, 2023. However, decoration work is under process which is expected to be completed by November 2023 after which H Ltd. will be able to start using the said asset for its own use. H Ltd. wants to capitalize the eligible borrowing costs incurred up to November 2023.

Solution

The capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale is completed.

In the given case, H Ltd. should capitalize borrowing costs only up to May 31, 2023. The borrowing cost incurred thereafter cannot be capitalized as the asset was ready for its intended use on May 31, 2023. The fact that decoration work was being carried out should not be considered as the asset was ready for its intended use on May 31, 2023

Question 13 *(ICAI Study Material)* *Pg no.*_____

ABC Ltd. is in the process of getting an entertainment park constructed. For this purpose, it has taken loan from a bank. The said park consists of several rides and facilities, each of which can be used individually. Three fourth part of the park has been constructed and can be opened up for public, while construction on the remaining part is continuing. Whether the capitalization of borrowing cost should continue for whole park until construction continues?

Solution

ABC Ltd. is in process of constructing an entertainment park which consists of several rides and facilities that can operate independently for their intended use. Even though the park as whole is not complete, the individual facilities are ready for their intended use.

The cessation of capitalization depends upon the nature of the qualifying assets, particularly where the qualifying assets consists of various parts. There are qualifying assets where each part is capable of being used while the construction continues on other parts. There are qualifying assets where all parts have to be completed before any earlier completed part can be put to use.

Since in the given scenario, the individual facilities are capable of operating independently and are ready for their intended use, therefore the borrowing costs shall cease to be capitalized for the three-fourth part of the project.

Question 14 *(RTP May 2022)* *Pg no.*_____

An enterprise has constructed a complex piece of equipment (qualifying asset) that is to be installed on the production line of a manufacturing plant. The equipment has been constructed over a period of 15 months. However, on installation, certain calibrations are required to achieve the desired level of production before it is finally commissioned. This process is expected to take approximately 2 months during which test runs will be made. Should the borrowing costs attributable to borrowings pertaining to the 2 months test run period be capitalized?

Solution

As per AS 16 Borrowing Costs "Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete". On installation of the equipment, an evaluation has to be made to conclude whether substantially all the activities necessary to prepare the asset are complete. After an equipment has been installed it is usually tested and adjusted for commercial production before it is finally commissioned. The calibrations and adjustments required during this period are performed in order to bring the equipment up to the stage at which it is ready to commence commercial production. Until the asset reaches the stage when it is ready to support commercial levels of production, it is not appropriate to conclude that substantially all the activities necessary to prepare the asset are complete. Thus, the borrowing cost incurred during the normal period of test runs (after the installation) are required to be capitalized.

Question 15 *(RTP Nov 2018)* *Pg no.*_____

A company incorporated in June 2021, has setup a factory within a period of 8 months with borrowed funds. The construction period of the assets had reduced drastically due to usage of technical innovations by the company. Whether interest on borrowings for the period prior to the date of setting up the factory should be capitalized although it has taken less than 12 months for the assets to get ready for use. You are required to comment on the necessary treatment with reference to AS 16.

Solution

As per AS 16 'Borrowing Costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale

Further, Explanation to the above para states that what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered.

The above paras imply that there is a rebuttable presumption that a 12 months period constitutes substantial period of time.

Under present circumstances where construction period has reduced drastically due to technical innovation, the 12 months period should at best be looked at as a benchmark and not as a conclusive yardstick. It may so happen that an asset under normal circumstances may take more than 12 months to complete. However, an enterprise that completes the asset in 8 months should not be penalized for its efficiency by denying it interest capitalization and vice versa.

The substantial period criteria ensures that enterprises do not spend a lot of time and effort capturing immaterial interest cost for purposes of capitalization.

Therefore, if the factory is constructed in 8 months then it shall be considered as a qualifying asset. The interest on borrowings for the same shall be capitalised although it has taken less than 12 months for the asset to get ready to use.

Question 16 *(RTP May 2021)* *Pg no._____*

Shan Builders Limited has borrowed a sum of US $ 10,00,000 at the beginning of Financial Year 2021-22 for its residential project at 4 %. 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, 2022 ₹ 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 & exchange difference for the year ending 31st March, 2022 as per applicable Accounting Standards.

Solution

a) Interest for the period 2021-22 = US$ 10 lakhs x 4% × ₹ 62 per US$ = ₹24.80 lakhs
b) Increase in liability towards the principal amount = US $ 10 lakhs × ₹ (62 - 56) = ₹ 60 lakhs
c) Interest that would have resulted if the loan was taken in Indian currency = US$ 10 lakhs × ₹ 56 x 10.5% = ₹ 58.80 lakhs
d) Difference between interest on local currency borrowing and foreign currency borrowing = ₹ 58.80 lakhs - ₹ 24.80 lakhs = ₹34 lakhs.

Therefore, out of ₹ 60 lakhs increase in the liability towards principal amount, only ₹ 34 lakhs will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 58.80 lakhs being the aggregate of interest of ₹ 24.80 lakhs on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 34 lakhs.

Hence, ₹ 58.80 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining ₹ 26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

Question 17 *(RTP May 2023)* *Pg no._____*

ABC Builders Limited had borrowed a sum of US $ 15,00,000 at the beginning of Financial year 2021-22 for its residential project at London Interbank Offered Rate (LIBOR) + 4 %. The interest is payable at the end of the Financial Year. At the time of availing the loan, the exchange rate was ₹ 72 per US $ and the rate as on 31st March, 2022 was ₹ 76 per US $. If ABC Builders Limited borrowed the loan in Indian Rupee equivalent, the pricing of loan would have been 9.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2022 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

Solution

(i) Interest for the period 2021-22 = US $ 15 lakhs x 5% × ₹ 76 per US $ = ₹ 57 lakhs
(ii) Increase in liability towards principal amount = US $ 15 lakhs × ₹ (76 - 72) = ₹ 60 lakhs.
(iii) Interest that would have resulted if the loan was taken in Indian currency = US $ 15 lakhs × ₹ 72 x 9.5% = ₹ 102.6 lakhs
(iv) Difference between interest on local currency borrowing and foreign currency borrowing= ₹ 102.6 lakhs - ₹ 57 lakhs = ₹ 45.6 lakhs.

Therefore, out of ₹ 60 lakhs increase in the liability towards principal amount, only ₹ 45.60 lakhs will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 102.60 lakhs being the aggregate of interest of ₹ 57 lakhs on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 45.60 lakhs. Hence, ₹ 102.60 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining ₹ 14.4 lakhs (60 - 45.60) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

SEGMENT REPORTING

AS 17

Objective	To establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements: (a) better understand the performance of the enterprise; (b) better assess the risks and returns of the enterprise; and (c) make more informed judgements about the enterprise as a whole
Business segment	A distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. *Factors that should be considered in determining whether products or services are related include:* (a) the nature of the products or services; (b) the nature of the production processes; (c) the type or class of customers for the products or services; (d) the methods used to distribute the products or provide services; and (e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.
Geographical segment	A distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. *Factors that should be considered in identifying geographical segments include:* (a) similarity of economic and political conditions; (b) relationships between operations in different geographical areas; (c) proximity of operations; (d) special risks associated with operations in a particular area; (e) exchange control regulations; and (f) the underlying currency risks
Reportable segment	A business or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Standard.
Segment revenue	Aggregate of ✓ the portion of enterprise revenue that is directly attributable to a segment, ✓ the relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and ✓ revenue from transactions with other segments of the enterprise.

	Segment revenue does not include: ☒ extraordinary items as defined in AS 5 ☒ interest or dividend income, including interest earned on advances or loans to other segments unless operations of segment are primarily of a financial nature ☒ Gains on sale of investment or on extinguishment of debt unless operations of segment are primarily of a financial nature
Segment expense	Aggregate of ✓ the expense resulting from the operating activities of a segment that is directly attributable to the segment, and ✓ the relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment, and ✓ expense relating to transactions with other segments of the enterprise. **Segment expense does not include:** ☒ extraordinary items as defined in AS 5 ☒ interest expense, including interest incurred on advances or loans from other segments, unless operations of the segment are primarily of a financial nature; ☒ income tax expense; and ☒ general administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole.
Segment result	Segment revenue less Segment expense.
Segment assets	Those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. Segment assets do not include income tax assets & assets used for general enterprise or head office purposes
Segment liabilities	Those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. Segment liabilities do not include income tax liabilities and borrowings and other liabilities that are incurred for financing rather than operating purposes
Identifying Reportable Segments	Primary and Secondary Segment Reporting Formats ➢ The ***dominant source and nature of risks and returns*** of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. ➢ If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically & vice versa. *Organizational and management structure of an enterprise and its internal financial reporting system normally provide the best evidence of the predominant source of risks and returns of the enterprise for the purpose of its segment reporting*

Identifying Reportable Segments (Quantitative Threshold) (Materiality Test)	A business segment or geographical segment should be identified as a reportable segment if: ➢ its revenue from sales to external customers & from transactions with other segments is 10% or more of total revenue, external & internal, of all segments; or ➢ its segment result, whether profit or loss, is 10 % or more of – (i) the combined result of all segments in profit, or (ii) 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.
Points to remember	❖ A business segment or a geographical segment which is not a reportable segment may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item. ❖ If total external revenue attributable to reportable segments constitutes < 75% of the 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. **(Overall Test)** ❖ A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10% thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10% thresholds
Primary Reporting Format	An enterprise should disclose the following for each reportable segment: ➢ segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments; ➢ segment result; ➢ total carrying amount of segment assets; ➢ total amount of segment liabilities; ➢ total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets); ➢ total amount of expense included in the segment result for depreciation and amortization in respect of segment assets for the period; and ➢ total amount of significant non-cash expenses, other than depreciation and amortization in respect of segment assets, that were included in segment expense &, therefore, deducted in measuring segment result.
Secondary Reporting Format	An enterprise should disclose the following for each reportable segment: ➢ segment revenue from sales to external customers ➢ total carrying amount of segment assets; ➢ total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets); Reporting of only those segments is required which fulfill the 10% criterion. (Means reportable segments only)

Other Disclosures	In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable. An enterprise should comply with the requirements of this Standard fully and not selectively. If a single financial report contains both consolidated financial statements and separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no.*_____

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 *(ICAI Study Material)* *Pg no.*_____

ABC Limited has 5 segments namely A, B, C, D and E. The profit/loss of each segment for the year ended March 31st, 2012 is as follows:

Segment	Profit/(Loss) (₹ in crore)
A	780
B	1,500
C	(2,300)
D	(4,500)
E	6,000
Total	1,480

Identify the Reportable segments.

Question 3 *(ICAI Study Material)* *Pg no.*_____

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

Solution

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

Question 4 *(ICAI Study Material)* *Pg no.*_____

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.

Solution

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.

Question 5 *(RTP May 2018/Nov 2019/Nov 2020/May 2021/May/Nov 2022/Jan 2025 (Sim.)/(ICAI SM)* *Pg no._____*

A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?

Solution

AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.
Hence, the enterprise can have its own policy for pricing intersegment transfers and hence, inter-segment transfers may be based on cost, below cost or market price.
However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Question 6 *(ICAI Study Material)* *Pg no._____*

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

	₹ ('000)
Forging Shop Division	
Sales to Bright Bar Division	4,575
Other Domestic Sales	90
Export Sales	6,135
	10,800
Bright Bar Division	
Sales to Fitting Division	45
Export Sales to Rwanda	300
	345
Fitting Division	
Export Sales to Maldives	270

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

Question 7 *(RTP Nov 2018) / (ICAI Study Material)* *Pg no._____*

Calculate segment results of a manufacturing organization from the following information:

Segments	A	B	C	Total
Directly attributed revenue	5,00,000	3,00,000	1,00,000	9,00,000
Enterprise revenue (allocated in 5 : 4 : 2 basis)				1,10,000

Revenue from transactions with other segments				
Transaction from B	1,00,000		50,000	1,50,000
Transaction from C	10,000	50,000		60,000
Transaction from A		25,000	1,00,000	1,25,000
Operating expenses	3,00,000	1,50,000	75,000	5,25,000
Enterprise expenses (allocated in 5 : 4 : 2 basis)				77,000
Expenses on transactions with other segments				
Transaction from B	75,000		30,000	1,05,000
Transaction from C	6,000	40,000		46,000
Transaction from A		18,000	82,000	1,00,000

Question 8 *(RTP May 2019) / (ICAI Study Material)* *Pg no._____*

PK Ltd. has identified business segment as its primary reporting format. It has identified India, USA and UK as three geographical segments. It sells its products in the Indian market, which constitutes 70 percent of the Company's sales. 25 per cent is sold in USA and the balance is sold in UK. Is PK Ltd. as part of its geographical secondary segment information, required to disclose segment revenue from export sales, where such sales are not significant?

Solution

As per AS 17 if primary format of an enterprise for reporting segment information is business segments, it should also report segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

Accordingly, for the purposes of disclosing secondary segment information, PK Ltd is not required to disclose segment revenue from export sales to UK, since that segment does not meet the 10 per cent or more of enterprise revenue threshold. However, other secondary segment information as per AS 17 should be disclosed in respect of this segment if the thresholds prescribed in the AS 17 are met.

Question 9 *(RTP Nov 2021)* *Pg no._____*

(a) Company A is engaged in the manufacture of chemicals. The company manufactures five types of chemicals that have different applications. Can this company include more than one type of chemical in a single business segment? Comment.

(b) Is an enterprise required to disclose changes in the basis of allocation of revenue and expenses to segments? Explain.

Solution

(a) As per AS 17, "A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products of services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products of services;
(b) the nature of the productions processes;
(c) the type of class of customers for the products or services;
(d) the methods use to distribute the products or provide the services; and
(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities."

As per provisions of the standard, a single business segment does not include products and services with significantly differing risks and returns. Products and services included in a single business segment may be dissimilar with respect to one or several factors listed above but are expected to be similar with respect to majority of the factors.
In the present case, the Company should consider whether the chemicals with different applications, have similar risks end returns. For this purpose, the Company should ascertain whether one or more types of chemicals are related keeping in view the relevant factors including those given in the definition of business segment. Chemicals having different applications can be included in a single business segment if majority of the relevant factors including those listed above are similar. This would ensure that the chemicals having significantly different risks and returns are not included in a single business segment.

(b) As per AS 17, "Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable." It also states that "some changes in accounting policies relate specifically to segment reporting. Examples include changes in identification of segments and changes in the basis for allocating revenues and expenses to segments. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand and impact of such changes, this Statement requires the disclosure of the nature of change and the financial effect of the change, if reasonably determinable".
In view of the above, a change in the basis of allocation of revenue and expenses to segments is a change in the accounting policy adopted for segment reporting. Accordingly, if the change has a material financial effect on the segment information, a description of the nature of the change, and the financial effect of the change, if it is reasonably determinable, should be disclosed.

Question 10 - *(RTP May 2022) / (ICAI Study Material)* *Pg no._____*

Company A is engaged in the manufacture and sale of products, which constitute two distinct business segments. The products of the Company are sold in the domestic market only. The management information system of the Company is organized to reflect operating information by two broad market segments, rural and urban. Besides the two business segments, how should Company A identify geographical segments? Do geographical segments exist within the same country? Explain in line with the provisions of AS 17.

Solution

AS 17 explains that, "a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country".
Accordingly, to identity geographical segments, Company A needs to evaluate whether the segments reflected in the management information system function in environments that are subject to significantly differing risks and returns irrespective of the fact whether they are within the same country.
The Standard recognizes that, "Determining the composition of a business or geographical segment involves a certain amount of judgement…". Accordingly, while the management information system of the Company provides segment information for rural and urban geographical segments for the purpose of internal reporting, judgement is required to determine whether these segments are subject to significantly differing risks and returns based on the definition of geographical segment. In making such a judgement, aspect like

different pricing and other policies, e.g., credit policies, deployment of resources between different regions etc., may be considered for the purpose identifying 'urban and 'rural' as separate geographical segment.
Company A, in making judgment for identifying geographical segments, should also consider the relevance, reliability and comparability over time of segment information that will be reported. The Standard, explains that, "In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in the standard and the qualitative characteristics of financial statements. The qualitative characteristics include the relevance, reliability and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise."

Question 11 *(Inter Nov 2023) (5 Marks)* *Pg no.*_____

Chp Sep 26

Garnet Limited has 4 operating segments. The total revenue (internal and external) and assets are set out as below:

(₹ in Lakhs)

Segment	Inter Segment Sales	External Sales	Total Assets
Fan	3,200	10,900	23,700
Light	200	1,400	13,200
Lamp	0	1,500	4,200
Printer	1,100	200	3,400
TOTAL	**4,500**	**14,000**	**44,500**

How many reportable segments does Garnet Limited have as per the Revenue and Assets criteria given in AS 17? State Reasons for your answer.

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:
Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or
Its segment 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 segment Fan is reportable segment as its sales are more than 1,850 lakhs (10% of ₹ 18,500 lakhs).
On the basis of asset criteria, Fan and Light are reportable segments as their assets are more than 4,450 lakhs (10% of ₹ 44,500 lakhs).

In the given case 75% of External Revenue is ₹ 10,500 Lakhs (₹ 14,000 × 75%) and the total External Revenue from Reportable segments is ₹ 12,300 Lakhs.
Moreover, total external revenue attributable to reportable segment is also more than 75% of the total enterprise revenue.
So, no need to add Reportable segments.

PRACTICE QUESTIONS

Question 1 *(Inter Nov 2019) (5 Marks)* Pg no._____

Mac Ltd. gives the following data regarding its six segments:

₹ in lakhs

Particulars	A	B	C	D	E	A	Total
Segment Assets	80	160	60	40	40	20	400
Segment Results	100	(380)	20	20	(20)	60	(200)
Segment Revenue	600	1240	160	120	160	120	2,400

The accountant contends that segments 'A' and 'B' alone are reportable segments. Is he justified in his view? Discuss in the context of AS-17 'Segment Reporting'.

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

- Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or
- Its segment result whether profit or loss is 10% or more of:
  - ➢ The combined result of all segments in profit; or
  - ➢ The combined result of all segments in loss,

  whichever is greater in absolute amount; or
- Its segment assets are 10% or more of the total assets of all segments.

Further, if the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until at least 75% of total enterprise revenue is included in reportable segments.

Accordingly,
On the basis of turnover criteria segments A and B are reportable segments.
On the basis of the result criteria, segments A, B and F are reportable segments (since their results in absolute amount are 10% or more of ₹ 400 lakhs).
On the basis of asset criteria, all segments except F are reportable segments.
Since all the segments are covered in at least one of the above criteria all segments have to be reported upon in accordance with AS 17. Hence, the opinion of accountant is wrong.

Question 2 *(Inter Nov 2020) (5 Marks) / (RTP Nov 2023)* Pg no._____

The accountant of Parag Limited has furnished you with the following data related to its Business Divisions:

Division	A	B	C	D	Total
Segment Revenue	100	300	200	400	1,000
Segment Result	45	-70	80	-10	45
Segment Assets	39	51	48	12	150

You are requested to identify the reportable segments in accordance with the criteria laid down in AS 17.

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

- Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

- Its segment result whether profit or loss is 10% or more of:
  - ➢ The combined result of all segments in profit; or
  - ➢ The combined result of all segments in loss,

  whichever is greater in absolute amount; or
- Its segment assets are 10% or more of the total assets of all segments.

On the basis of revenue criteria, segments A, B, C and D - all are reportable segments.
On the basis of the result criteria, segments A, B and C are reportable segments (since their results in absolute amount is 10% or more of 125 Lakhs).
On the basis of asset criteria, all segments except D 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.

Question 3 *(Inter Jan 2021) (5 Marks) / (ICAI Study Material) (RTP May 20)/(May 23)* *Pg no._____*

The Senior Accountant of AMF Ltd. gives the following data regarding its five segments:

Division	P	Q	R	S	T	Total
Segment Assets	80	30	20	20	10	160
Segment Result	(190)	10	10	(10)	30	(150)
Segment Revenue	620	80	60	80	60	900

The Senior Accountant is of the opinion that segment "P" alone should be reported. Is he justified in his view? Examine his opinion in the light of provision of AS-17 'Segment Reporting'.

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

- Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or
- Its segment result whether profit or loss is 10% or more of:
  - ➢ The combined result of all segments in profit; or
  - ➢ The combined result of all segments in loss,

  whichever is greater in absolute amount; or
- Its segment assets are 10% or more of the total assets of all segments.

Accordingly,
(a) On the basis of revenue from sales criteria, segment P is a reportable segment.
(b) On the basis of the result criteria, segments P & T are reportable segments (since their results in absolute amount is 10% or more of 200 Lakhs).
(c) On the basis of asset criteria, all segments except T are reportable segments.

Since all the segments are covered in at least one of the above criteria, all segments have to be reported upon in accordance with AS 17. Hence, the opinion of chief accountant that only segment 'P' is reportable is wrong.

Question 4 *(Inter May 2023) (5 Marks)* *Pg no._____*

The Accountant of X. Ltd. provides the following data regarding its five segments:

Particulars	A	B	C	D	E	Total (₹ in crore)
Segment Assets	50	20	15	10	5	100
Segment Results	(85)	10	10	(15)	5	(75)
Segment Revenue	250	50	40	60	30	430

The accountant is of the opinion that segment 'A alone should be reported.
Is he justified in his view? Examine his opinion in the light of provisions of AS -17 Segment Reporting.

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

- Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or
- Its segment result whether profit or loss is 10% or more of:
  - ➢ The combined result of all segments in profit; or
  - ➢ The combined result of all segments in loss,

  whichever is greater in absolute amount; or
- Its segment assets are 10% or more of the total assets of all segments.

On the basis of revenue criteria, segments A, B and D are reportable segments.
On the basis of the result criteria, segments A, B, C and D are reportable segments (since their results in absolute amount are 10% or more of ₹ 100 crore).
On the basis of asset criteria, all segments except E are reportable segments.
Since all the segments except E are covered in at least one of the above criteria. Hence, all segments except E have to be reported upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant that only segment A alone should be reported, is wrong as all segments are reportable except E.

Question 5 *(Inter May 2022) (5 Marks) / (ICAI Study Material)* *Pg no._____*

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)

Solution

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:
(i) The combined result of all segments in profit; i.e. ₹ 250 Lakhs or
(ii) 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).

Question 6 *(Inter May 2018) (5 Marks)/(ICAI Study Material)* *Pg no._____*

M/s Nathan Limited has three segments namely P, Q and R. The assets of the company are ₹ 15 crores. Segment P has 4 crores, Segment Q has 6 crores and Segment R has 5 crores. Deferred tax assets included in the assets of each segment are P - ₹ 1 crore, Q - ₹ 0.90 crores and R - ₹ 0.80 crores.
The accountant contends all these three segments are reportable segments. Comment.

Solution
According to AS 17 "Segment Reporting", segment Assets do not include income tax assets. Therefore, the revised total assets are 12.3 crores [₹ 15 – (₹ 1 + 0.9 + 0.8).
Details of Segment wise assets
Segment P holds total assets of ₹ 3 crores (₹ 4 crores – ₹ 1 crores);
Segment Q holds ₹ 5.1 crores (₹ 6 crores – 0.9 crores);
Segment R holds ₹ 4.2 crores (₹ 5 crores – ₹ 0.8 crores).

Thus, all the three segments hold more than 10% of the total assets, all segments are reportable segments. Hence, the contention of the Accountant that all three segments are reportable segments is correct.

Question 7 *(ICAI Study Material)* *Pg no._____*

Heavy Goods Ltd. has 6 segments namely L-Q (below). The total revenues (internal and external), profits or losses and assets are set out below:

Segment	Inter Segment Sales	External Sales	Profit/ (Loss)	Total Assets
L	4,200	12,300	3,000	37,500
M	3,500	7,750	1,500	23,250
N	1,000	3,500	(1,500)	15,750
O	0	5,250	(750)	10,500
P	500	5,500	900	10,500
Q	1,200	1,050	600	5,250
	10,400	**35,350**	**3,750**	**1,02,750**

Heavy Goods Ltd. needs to determine how many reportable segments it has. You are required to advice Heavy Goods Ltd. as per the criteria defined in AS 17.

Solution
Quantitative Threshold Test:
Revenue Test:
Combined total sales of all the segment = ₹ 10,400 + ₹ 35,350 = ₹ 45,750.
10% thresholds = 45,750 x 10% = 4,575.

Profitability Test:
In the given situation, combined reported profit = ₹ 6,000 and combined reported loss (₹ 2,250). Hence, for 10% thresholds ₹ 6,000 will be considered.
10% thresholds = ₹ 6,000 x 10% = ₹ 60

Asset Test:
Combined total assets of all the segment = ₹ 1,02,750
10% thresholds = ₹ 1,02,750 x 10% = 10,275

Accordingly, quantitative thresholds are calculated below:

Segment	L	M	N	O	P	Q	Reportable Segments
% segment sales to total sales	36.66%	24.59%	9.84%	11.48%	13.11%	4.92%	L,M,O,P
% segment profit to total profits	50%	25%	25%	12.5%	15%	10%	L,M,N,O,P,Q
% segment assets to total assets	36.50%	22.63%	15.33%	10.22%	10.22%	5.11%	L,M,N,O,P

Conclusion:

Segments L, M, O and P clearly satisfy the revenue and assets tests and they are separate reportable segments. Segment N does not satisfy the revenue test, but it does satisfy the asset test and it is a reportable segment. Segment Q does not satisfy the revenue or the assets test but is does satisfy the profits test. Therefore, Segment Q is also a reportable segment.

Hence all segments i.e. L, M, N, O, P and Q are reportable segments

Question 8 *(RTP Sep 2024)* *Pg no.*_____

Whether interest expense relating to overdrafts and other operating liabilities identified to a particular segment should be included in the segment expense or not?

Solution

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories.

RELATED PARTY DISCLOSURES

AS 18

Scope	This Standard should be applied in reporting related party relationships and transactions between a reporting enterprise and its related parties. The requirements of this Standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.
Related Party Relationships	***Related party - parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.*** AS 18 deals only with related party relationships described in (a) to (e) below: a) Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries). b) Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture. c) Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual. d) Key management personnel and relatives of such personnel and e) Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.
No Related Parties	***The following are deemed not to be related parties:*** a) Two companies simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings). b) A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and c) The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process): ❖ Providers of finance ❖ Trade unions ❖ Public utilities ❖ Government departments and government agencies including government sponsored bodies

Important Definitions	**Related party transaction**	A transfer of resources or obligations between related parties, regardless of whether or not a price is charged.
	Control	➢ ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or ➢ control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or ➢ a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.
	Significant influence	Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies. Significant influence may be exercised in several ways, for example, (1) by representation on the board of directors;, (2) participation in the policy making process; (3) material inter-company transactions, (4) interchange of managerial personnel or (5) dependence on technical information. Significant influence may be gained by share ownership, statute or agreement.
	Key management personnel	Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. ***For example,*** in the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.
	Substantial interest	An enterprise is considered to have a substantial interest in another enterprise if that enterprise owns, directly or indirectly, 20% or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20% or more interest in the voting power of the enterprise.
The Related Party Issue	➢ Related party relationships are a normal feature of commerce and business. ➢ Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties.	

	➢ The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. ➢ Sometimes, transactions would not have taken place if the related party relationship had not existed.
Disclosure Requirements	***Name*** of the related party and ***nature of*** the related party ***relationship*** where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties. If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following: → The name of the transacting related party; → A description of the relationship between the parties; → A description of the nature of transactions; → Volume of the transactions either as an amount or as an appropriate proportion; → Any other elements of the related party transactions necessary for an understanding of the financial statements; → The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; → Amounts written off or written back in the period in respect of debts due from or to related parties.
Exceptions of disclosure requirements	➢ Related party disclosure requirements as laid down in AS 18 do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority. ➢ No disclosure is required in consolidated financial statements in respect of intragroup transactions. ➢ No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)*

Identify the related parties in the following cases as per AS 18:
A Ltd. holds 51% of B Ltd.
B Ltd holds 51% of O Ltd.
Z Ltd holds 49% of O Ltd.

Solution

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

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

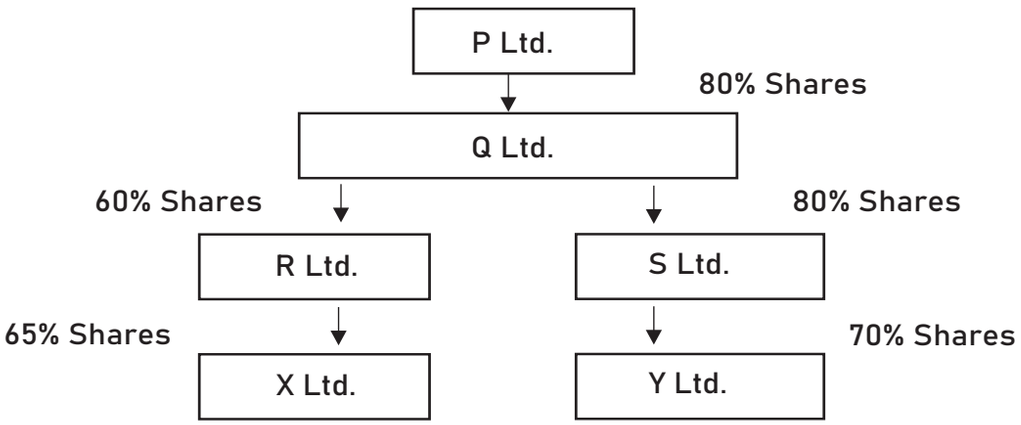
Reporting enterprise - O Ltd.
- A Ltd. (ultimate holding company) is a related party
- B Ltd. (holding company) is a related party
- Z Ltd. (investor/ investing party) is a related party (O Ltd. being Associate of Z Ltd.)

Reporting enterprise - Z Ltd.
- O Ltd. (associate) is a related party

Question 2 *(ICAI Study Material)*

*Pg no.*_____

Consider the following organization structure related to P Ltd.



Given the above structure: Identify related party relationships, if R Ltd. is reporting enterprise

Solution

The following table identifies related party relationships for R Ltd. (being reporting enterprise)

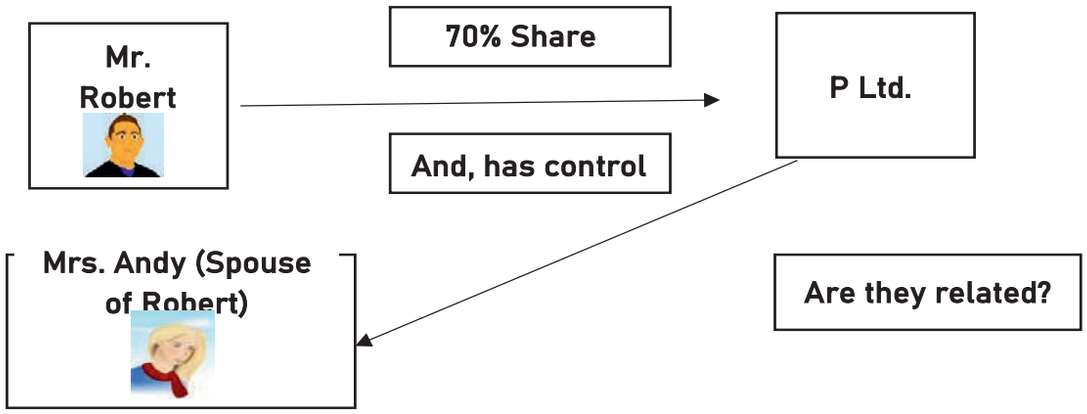
Party Name	Relationship under AS-18
P Ltd.	• P Ltd. has indirect control on R Ltd. (through Q Ltd.) • Hence R Ltd. is related to P Ltd.
Q Ltd.	• Q Ltd. has direct control of R Ltd. • Hence R Ltd. is related to Q Ltd.
S Ltd.	• R Ltd. and S Ltd. are under common control of Q Ltd. • Hence R Ltd. is related to S Ltd.
X Ltd.	• X Ltd. is controlled by R Ltd. • Hence R Ltd. is related to X Ltd.

Y Ltd.	• Y Ltd. is the sub-subsidiary of Q Ltd. • Both R Ltd. and Y Ltd. are under common control of Q Ltd. • Hence R Ltd. is related to Y Ltd.

Question 3 *(ICAI Study Material)* *Pg no.*_____

Consider a scenario wherein:

- Mr. Robert holds 70% shares and voting rights in P Ltd



Determine: Whether Andy (spouse of Mr. Robert) is a related party to P Ltd. under AS-18?

Solution

Yes – Andy is a related party to P Ltd., in view of the requirements of AS-18.

It may be recalled that under AS-18 'relatives of individuals owning an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise' are considered as related parties.

Question 4 *(RTP May 2020) / (ICAI Study Material)*

Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3-2020. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant, correct?

Solution

As per 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.

Question 5 *(ICAI Study Material)*

A) Mr. Raj a relative of key management personnel received remuneration of ₹ 2,50,000 for his services in the company for the period from 1.4.2019 to 30.6.2019. On 1.7.2019, he left the service. Should the relative be identified as at the closing date i.e. on 31.3.2020 for the purposes of AS 18?

Solution

According to AS 18 on 'Related Party Disclosures', parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Raj, a relative of key management personnel should be identified as related party for disclosure in the financial statements for the year ended 31.3.2020.

B) X Ltd. sold goods to its associate Company during the 1st quarter ending 30.6.2019. After that, the related party relationship ceased to exist. However, goods were supplied as were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.

Solution

As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2019 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist would not be reported.

Question 6 *(ICAI Study Material)* *Pg no.*_____

Consider a scenario wherein:

- UK Bank holds 23% equity shares with voting rights in P Ltd.
- The bank has provided a loan of Rs. 20 million to P Ltd. at market interest rate
- As per the terms and conditions of the loan agreement, the bank has appointed one person as its nominee to the board of directors of P Ltd. and any major transaction to be entered into by P Ltd. will require the consent of the Bank.

Determine: Whether under AS-18 - UK Bank is a related party to P Ltd. (the reporting enterprise)?

Solution

In the instant case, the UK Bank holds 23% shares with voting rights in P Ltd. and hence is deemed to exercise significant influence over P Ltd.

The bank is also a provider of finance to P Ltd. (the reporting enterprise) and as per AS-18, parties like providers of finance are deemed not to be considered as a related party in the course of normal dealings with an enterprise by virtue only of those dealings. However, this exemption will not be available to UK Bank in this case – since it exercises significant influence over P Ltd. (by virtue of holding 23% shares with voting rights in P Ltd.)

Accordingly, for P Ltd. (the reporting enterprise), the UK Bank is a related party and it will be required to disclose the transactions with UK Bank in its financial statements.

Question 7 *(RTP May 2019) / (RTP Nov 2019) / (RTP Nov 2022)*

SP hotels Limited enters into an agreement with Mr. A for running its hotel for a fixed return payable to the later every year. The contract involves the day-to-day management of the hotel, while all financial and operating policy decisions are taken by the Board of Directors of the company. Mr. A does not own any voting power in SP Hotels Limited. Would he be considered as a related party of SP Hotels Limited"?

Solution

Mr. A will not be considered as a related party of SP Hotels Limited in view of paragraph 3(c) of AS 18 which states, "individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual".

In the above example, in the absence of share ownership, Mr. A would not be considered to exercise significant influence on SP Hotels Limited, even though there is an agreement giving him the power to manage the company.
Further, the fact that Mr. A does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel

Question 8 *(RTP May 2018) / (RTP May 2023) (Similar)*

Is remuneration paid to Key Managerial Personnel or Non Executive Directors or Board of Directors a related party transaction?

Solution

Key Managerial Personnel (KMP) are those persons who have the authority and responsibility for planning, directing & controlling the activities of the reporting enterprise.

In case of a company, the Managing Director, Whole time Director, Manager & any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered KMP.
Persons who do not have the authority & responsibility for planning, directing & controlling the activities of the enterprise would not be KMP. Conversely, persons without any formal titles may be considered to be KMP, if they plan, direct & control the activities of the enterprise.

A non executive director may not be involved in either of these activities mentioned above. In fact besides his activity is more in the nature of an advisory and guiding function. Even if he is involved in planning stage, being non executive, he will not be involved in controlling the activities. Hence remuneration paid to nonexecutive director is not a related party transaction.

Further as per Companies Act, 2013 a related party includes a director or his relative. The Act defines a director as a director appointed to the Board of a company. Therefore as per Companies Act, a non executive director would be considered as a related party. Hence remuneration paid to them will be considered as related party transaction.

Question 9 *(RTP Nov 2021)*

(a) Omega Bank Limited holds 25 per cent of the voting power of B Limited. Omega Bank Limited also provides finance by way of a loan to B Limited at market rates of interest, on account of which, Omega Bank Limited would have the power to nominate one person to the board of directors of B Limited. Any major transactions proposed to be entered into by B Limited would need the consent of Omega Bank Limited. Would Omega Bank Limited be considered as related party for B Ltd. (reporting enterprise)?

(b) A Limited has two Associates, B Limited and C Limited, and owns 25 per cent of the voting power of B Limited and 30 per cent of the voting power of C Limited. Would B Limited be considered a related party for the purpose of financial statements of C Limited?

Solution

(a) Omega Bank Limited would be a related party of B Limited. As per AS 18 "associates and joint ventures of the reporting enterprise and the investing party of venture in respect of which the reporting enterprise is an associate or a joint venturer" are related party relationship. Further, an associate has been defined as "an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of the party". Significant influence has been defined to be "participation in the financial and /or operating policy decisions of an enterprise, but not control of those policies". Further, it is given in the standard that significant influence may be gained by

share ownership, agreement or statute. As regards share ownership, there is a presumption that ownership of 20 per cent or more of the voting power enables the enterprise to exercise significant influence, unless it could be clearly demonstrated otherwise. In the given example, Omega Bank Limited exercises significant influence over B Limited by virtue of ownership of 25 per cent of the voting power.

Omega Bank Limited is also a provider of finance for B Limited (as it has provided a loan to B Limited), and as per the standard, a provider of finance is deemed not to be a related party during its normal dealings with the enterprise by virtue only of those dealing. However, in this case, the exemption would not be available to Omega Bank Limited as the exercise of significant influence of Omega Bank Limited over B Limited has been demonstrated on account of ownership of more than 20 per cent of voting power. Accordingly, Omega Bank Limited would be construed to be a related party in the financial statements of B Limited and consequently, the latter would be required to disclose the transactions with Omega Bank Limited in its financial statements.

(b) Both B Limited and C Limited are 'associates' of A Limited. Fellow-associates cannot be regarded as a related parties only by virtue of the relationship. AS 18 states that "enterprise that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise" are related parties. Further, it is given that "associates and joint ventures of the reporting enterprise and the investing party or venture in respect of which the reporting enterprise is an associate or a joint venturer" are also related parties. As B Limited is not an associate of C Limited, nor is it being controlled, directly or indirectly, by C Limited or is not so controlling C Limited, it is not a related party of C Limited.

Question 10 *(ICAI Study Material)*

ABC Limited is in the business of manufacturing textiles. It has certain commercial contracts with its customers and those customer contracts carry various clauses, imposing restriction on ABC Limited for disclosure of certain information. Accordingly, the company doesn't intend to provide related party disclosure under AS-18 in its ensuing financial statements. Is this correct?

Solution

As per AS-18 stipulate that related party disclosure requirements under AS-18 do not apply in circumstances, where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality, as specifically required in terms of a statute or by any regulator or similar competent authority.

In case, where (1) a statute or (2) a regulator or (3) a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information, which is required to be disclosed as per AS 18, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and AS-18 would not override the obligation to preserve the confidentiality of customers' dealings.

However, this exemption is not available in respect of confidentiality provisions in a commercial contract between two enterprises - where confidentiality is not specifically required in terms of (1) a statute or (2) by any regulator or (3) similar competent authority.

Therefore, in the given case AS-18 related party disclosures would have to be made by ABC Limited in its ensuing financial statements.

Question 11 *(RTP Jan 2025)*

Will transactions with related parties, for services provided/received free of cost, be required to be disclosed?

A Limited has a corporate communications department, which centralises the public relations function for the whole group of A Limited and its subsidiaries. No charges are, however, levied by A Limited on its subsidiaries and accordingly, these transactions are not given accounting recognition. Would these constitute related party transactions requiring disclosure under AS 18 in the standalone financial statements of A Limited?

Solution

These transactions would require disclosure under AS 18 in the standalone financial statements of A Limited. As per paragraph 10 of AS 18, a related party transaction is "a transfer of resources or obligations between related parties, regardless of whether or not a price is charged". In the given situation, there is a transfer of resources from A Limited to its subsidiaries, though no price is charged for the same. Hence, it will constitute as related party transaction and will require disclosure in the financial statements of A Ltd.

Question 12 *(Inter Jan 2025) (4 Marks)*

The following information is provided for the year ended 31st March, 2024:

a) AX Limited holds 70% shares of BX Limited
b) BX Limited holds 30% shares of CX Limited
c) DX Limited holds 40% shares in CX Limited
d) DX Limited holds 49% shares in EX Limited

You are required to:

(i) Identify the related parties for the reporting entities AX Limited, CX Limited and EX Limited.
(ii) If DX Limited would have sold its investment in EX Limited on 1st October, 2023, but goods were continued to be supplied by DX Limited to EX Limited throughout the year, will this scenario change your answer with respect to any of reporting entity mentioned in point (i)?

Give reasons for your answer as per AS 18.

PRACTICE QUESTIONS

Question 1 *(Inter May 2019) (5 Marks) / (ICAI Study Material) / (RTP Nov 2023)*

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

(i) Maya Ltd. holds 61 % shares of Sheetal Ltd.
Sheetal Ltd. holds 51 % shares of Fair Ltd.
Care Ltd. holds 49% shares of Fair Ltd.
(Give your answer - Reporting Entity wise for Maya Ltd., Sheetal Ltd., Care Ltd. and Fair Ltd.)

(ii) Mr. Subhash Kumar is Managing Director of A Ltd. and also holds 72% capital of B Ltd.

Solution

(i)

(a) Reporting entity- Maya Ltd.
- Sheetal Ltd. (subsidiary) is a related party
- Fair Ltd.(subsidiary) is a related party

(b) Reporting entity- Sheetal Ltd.
- Maya Ltd. (holding company) is a related party
- Fair Ltd. (subsidiary) is a related party

(c) Reporting entity- Fair Ltd.
- Maya Ltd. (ultimate holding company) is a related party
- Sheetal Ltd. (holding company) is a related party
- Care Ltd. (investor/ investing party) is a related party

(d) Reporting entity- Care Ltd.
- Fair Ltd. (associate) is a related party

(ii) Mr. Subhash Kumar is Key management personnel as he has the authority for planning, directing and controlling the activities of A Ltd. He also holds substantial interest in B Ltd. as he holds 72% capital of B Ltd. Thus, Mr. Subhash is related party for both A Ltd. and B Ltd. Moreover, as per the definition of related party relationship described in para 3 of AS 18, enterprises over which Subhash is able to exercise significant influence are also related parties. Thus, A Ltd. and B Ltd. will also be construed as related to each other.

Question 2 *(RTP Nov 2020)*

(a) Identify the related parties in the following cases as per AS-18
X Ltd. holds 60 % shares of Y Ltd.
Y Ltd. holds 55 % shares of W Ltd.
Z Ltd. holds 35% shares of W Ltd.

(b) Himalaya Ltd. sold goods for ₹ 40 lakhs to Aravalli Ltd. during financial year ended 31st March 2020. The Managing Director of Himalaya Ltd. owns 80% shares of Aravalli Ltd. The sales were made to Aravalli Limited at normal selling prices followed by Himalaya Ltd. The Chief accountant of Himalaya 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 AS 18. You are required to comment on this.

Solution

A) X Ltd., Y Ltd. & W Ltd. are related to each other. Z Ltd. & W Ltd. are related to each other by virtue of associate relationship. However, neither X Ltd. nor Y Ltd. is related to Z Ltd. and vice versa since neither control nor does significant influence exist between them.

B) Himalaya Ltd. and Aravalli Ltd. are related parties since key management personnel of Himalaya Ltd. i.e. its managing director holds 80% shares in Aravalli Ltd. and hence disclosure of transaction between them is required irrespective of whether transaction was done at normal selling price. Hence the contention of Himalaya Ltd. that these sales require no disclosure under related party transactions is wrong.

Question 3 *(ICAI Study Material)* *Pg no.*_____

Consider a scenario wherein:

- A Ltd. has 60% voting right in B Ltd.
- A Ltd. also has 22% voting right in C Ltd.; and
- B Ltd. has 30% voting right in C Ltd.

Whether C Ltd. is to be treated under AS-18 as a party related to A Ltd.?

Solution

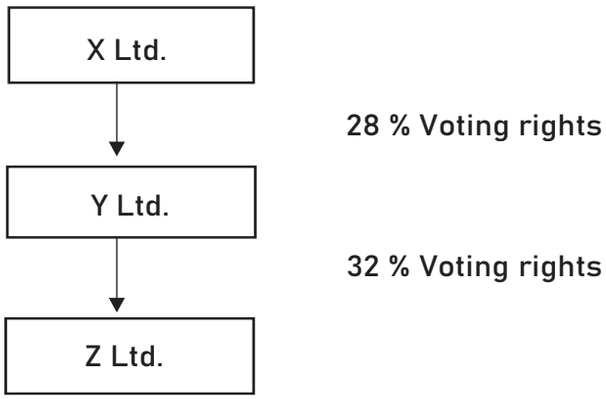
Yes – in relation to A Ltd. (the reporting enterprise), C Ltd. is a related party under AS-18. This is because A Ltd. indirectly controls C Ltd.

In this case, A Ltd. (together with its subsidiary B Ltd.) controls more than one half of the voting rights of C Ltd.

Question 4 *(ICAI Study Material)* *Pg no.*_____

Consider a scenario wherein:

- X Ltd. holds 28% voting right in Y Ltd. (and hence Y Ltd. is an associate of X Ltd.)
- Y Ltd. holds 32% voting right in Z Ltd. (and hence Z Ltd. is an associate of Y Ltd.)



In the above case, since Y Ltd. is an associate of X Ltd. – Y Ltd. is a related party to X Ltd. Likewise, since Z Ltd. is an associate of Y Ltd. - Z Ltd. is a related party to Y Ltd. The question is: Whether Z Ltd. is to be treated under AS-18 as a party related to X Ltd.?

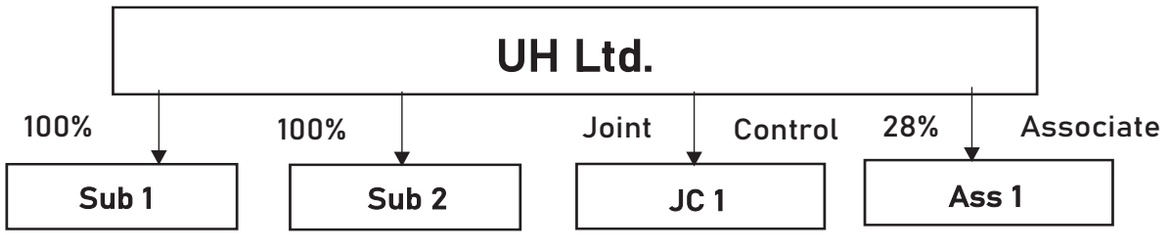
Solution

No – in relation to X Ltd. (the reporting enterprise), Z Ltd. is a **not** a related party. This is because as per the requirements of AS-18, 'associate of an associate' is **not** a related party.

Question 5 *(ICAI Study Material)* *Pg no.*_____

Consider the following organization structure related to UH Ltd. (the ultimate parent company of a Group), wherein UH Ltd. has made the following investments:

- Investment in two of the wholly owned subsidiaries, viz. Sub 1 and Sub 2
- Investment in JC 1, in which UH Ltd. has a joint control
- 28% investment in Ass 1 (and hence, Ass 1 is an associate of UH Ltd.)



Given the above structure: Identify related party relationships for each of the above entities under AS-18

Solution

The following table identifies related party relationships for each of the entities in the Group:

Reporting Enterprise	Related Party as per AS-18
UH Ltd.	All the four entities (viz. Sub 1, Sub 2, JC 1 and Ass 1)
Sub 1	Only two of the entities in the Group (viz. UH Ltd. and Sub 2)
Sub 2	Only two of the entities in the Group (viz. UH Ltd. and Sub 1)
JC 1	Only UH Ltd.
Ass 1	Only UH Ltd.

Question 6 *(RTP Nov 2018)*

Sun Ltd. sold goods for ₹ 50 lakhs to Moon Ltd. during financial year ended 31st March 2020 at normal selling price followed by Sun Ltd. The Managing Director of Sun Ltd. holds 75% shares of Moon Ltd. The Chief accountant of Sun 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. You are required to examine and advise whether the contention of the Chief Accountant is correct?

Solution

As per AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise. In the given case, Sun Ltd. and Moon 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 Sun Ltd is wrong.

Question 7 *(ICAI Study Material)*

*Pg no.*_____

Consider a scenario wherein:

- Mr. Robert is a Managing Director of P Ltd.
- Andy (spouse of Robert) received a remuneration of Rs 5 lacs from P Ltd. – for the services she rendered to P Ltd. for the period 1st April 2021 through 30th June 2021
- Andy left the services of P Ltd. on 1st July 2021
- Consider 31st March 2022 as the year-end date for P Ltd.

Whether Andy is to be identified as related party at the year-end date (31st March 2022) for the purposes of AS-18?

Solution

Yes – This is because as per AS-18, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Hence Andy (being the spouse and relative of the KMP of P Ltd.) needs to be reported as related party at the year-end date (i.e. 31st March 2022). This is because the remuneration Andy received from P Ltd. (for the period April 2021 to 30 June 2021) falls within the reporting year April 2021 to March 2022.

Question 8 – *(ICAI Study Material)* *Pg no._____*

Consider a scenario wherein:

a. P Ltd. hold 22% shares and voting rights in Q Ltd. (and hence Q Ltd. is an associate of P Ltd.)
b. On 1st April 2021, P Ltd. sold certain goods to Q Ltd. amounting to Rs. 5 lacs
c. On 30th June 2021, P Ltd. sold its entire 22% stake in Q Ltd. (and hence the related party relationship ceased to exist after 30th June 2021)
d. However, P Ltd. continued supply goods to Q Ltd. subsequent to 30th June 2021 (just like any other customer) and sold goods worth Rs. 15 lacs during 9-month period ended 31st March 2022
e. Consider 31st March 2022 as the year-end date for P Ltd.

Determine whether the transaction for the entire year (ending on 31st March 2022) is required to be disclosed under AS-18 as related party transaction.

Solution

No – This is because as per AS-18, the disclosure requirements under the Standard relate only to the period during related party relationship existed.

Accordingly, only transactions between P Ltd and Q Ltd till 30th June 2021 (being sale of goods worth Rs. 5 lacs) are required to be reported / disclosed under AS- 18.

Transactions entered into after 30th June 2021 are not required to be disclosed under AS-18.

Question 9 *(Inter Nov 2018) (5 Marks)*

Following transactions are disclosed as on 31st March, 2018:

a) Mr. Sumit, a relative of Managing Director, received remuneration of ₹ 2,10,000 for his services in the company for the period from 1st April, 2019 to 30th June, 2019. He left the service on 1st July, 2019. Should the relative be identified as a related party as on closing date i.e. on 31-3-2020 for the purpose of AS-18.
b) Goods sold amounting to ₹ 50 lakhs to associate company during the 1st quarter ended on 30th June, 2019. After that related party relationship ceased to exist. However, goods were supplied as was supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transactions.

Solution

a) According to AS 18 'Related Party Disclosures', parties are considered to be related if at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Sumit a relative of key management personnel should be identified as related party as at the closing date i.e. on 31.3.2020 as he received remuneration for his services in the company from 1st April, 2019 to 30th June, 2019 and this period comes under the reporting period.

b) As per provision of AS 18, the transactions only for the period in which related party relationships exist need to be reported. Hence, transactions of the entity with its associate company for the first quarter ending 30.06.2019 only are required to be disclosed as related party transactions. Transactions of the entire year need not be disclosed as related party transactions and transactions for the period (after 1st July) in which related party relationship did not exist need not be reported. Hence transaction of sale of goods with the associate company for first quarter ending 30th June, 2019 for ₹ 50 Lakhs only are required to be disclosed as related party transaction on 31.3.20.

Question 10 *(Inter July 2021) (5 Marks) / (RTP May 2024)*

Chp Sep 26

(i) Khushi Limited enter into an agreement with Mr. Happy for running a business for a fixed amount payable to the later every year. The contract states that the day-to-day management of the business will be handled by. Mr. Happy, while all financial and operating policy decisions are taken by the Board of Directors of the Company. Mr. Happy does not own any voting power in Khushi Limited.

(ii) Shri Bhanu a relative of key management personnel received remuneration of ₹ 3,50,000 for his services in the company for the period from 1st April, 2020 to 30th June, 2020. On 1st July, 2020, he left the service.

You are required to suggest how the above transactions will be treated as at the closing date i.e. on 31st March, 2021 for the purposes of AS 18- Related Party Disclosures.

Solution

(i) Mr. Happy will not be considered as a related party of Khushi Limited in view of provisions of AS 18 "Related Party Disclosures" which states, "individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual are related parties".

In the given case, in the absence of share ownership, Mr. Happy would not be considered to exercise significant influence on Khushi Limited, even though there is an agreement giving him the power to manage the company. Further, the fact that Mr Happy does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel.

(ii) According to AS 18 on 'Related Party Disclosures', parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Hence, Shri Bhanu, a relative of key management personnel should be identified as related party for disclosure in the financial statements for the year ended 31.3.2021 as he received remuneration for his services in the company for the period from 1st April,2020 to 30th June,2020.

Question 11 *(ICAI Study Material)* *Pg no.*_____

Who are related parties under AS 18? What are the related party disclosure requirements?

Solution

Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

a) the name of the transacting related party;

b) a description of the relationship between the parties;
c) a description of the nature of transactions;
d) volume of the transactions either as an amount or as an appropriate proportion;
e) any other elements of the related party transactions necessary for an understanding of the financial statements;
f) the amounts or appropriate proportions of outstanding items pertaining to related parties at balance sheet date & provisions for doubtful debts due from such parties at that date; &
g) amounts written off or written back in the period in respect of debts due from or to related parties.

Question 12 *(Inter May 2023) (5 Marks)* *Pg no._____*

Answer the following with respect to AS-18:

a. ABC Ltd. sold goods of ₹ 2,00,000 to its associate company for the 1st quarter ending 30.06.2022. After that the related party relationship ceased to exist. However, goods were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transactions.
b. If the majority of directors of Arjun Ltd. constitute the majority of the Board of another Company Bheem Ltd. in their individual capacity as professionals (and not by virtue of their being Directors in Arjun Ltd.). Are both the companies related?
c. Asha Ltd. sells all the manufactured furniture of ₹1,00,00,000 to Sasha Ltd. as per agreement. Sasha Ltd. is the only customer to Asha Ltd. In the financial statements, Asha Ltd. wants to present Sasha company as a related party. Comment on the disclosure requirement.

Solution

a) As per AS 18, parties are considered to be related if any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party. Transactions of ABC Ltd. with its associate company for the first quarter ending 30.06.2022 only are required to be disclosed as related party transactions as the company has the ability to exercise significant influence only till 30.6.2022.
The transactions for the period in which related party relationship did not exist need not be reported.

b) In the given case, Arjun Ltd. cannot be said to control the composition of board of directors of Bheem Ltd. as the directors have been appointed in their individual capacity as professionals and not by virtue of their being directors in Arjun Ltd.
Hence, it cannot be concluded that the companies are related merely because the majority of the directors of one company became the majority of the directors of the second in their individual capacity as professionals.

c) In the context of AS 18, a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business cannot be construed as Related Party Relationship merely by virtue of the resulting economic dependence. There is an economic dependence between the companies but no one controls or exercise significant influence on the other.
In the given case, Asha Ltd. need not report Sasha Company as its related party in its financial statements.

Question 13 *(RTP May 2022)*

In respect of a key supplier who is dependent on the company for its existence and the company enjoys influence over the prices of this supplier (which may not be formally demonstrable), can the supplier and the company be considered as related parties?

Solution

The supplier and the company cannot be considered to be related parties merely because the latter is able to influence the transaction price between the parties. Paragraph 3 of AS 18 states that "enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise" are considered to be related party relationships. However, the conditions which define the existence of control, as follows, are not satisfied in the given example.

- 'ownership, directly or indirectly, of more than one-half of voting power of an enterprise, or
- Control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or
- a substantial interest in voting power and the power to direct, by statue or agreement, the financial and/or operating policies of the enterprise".

Paragraph 10 of the standard defines significant influence as "participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies". In the given example, although the supplier and the company have entered into a commercial transaction, the terms of which are influenced by the latter because of its better bargaining power in the specific market for such goods, it cannot be concluded that there is participation in the financial and/or operating policy decisions. Therefore, as the conditions specified by the Standard for being classified as a related party are not satisfied in the given example, the company cannot be said to be related to the supplier. This view is supported by paragraph 4 (b) of the Standard which states that "a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence" would not be deemed to be related parties.

Question 14 – *(ICAI Study Material)*

Should the related parties be identified as at the reporting date (i.e. balance sheet date) for the purposes of AS-18? In disclosing transactions with related parties, are the transactions of the entire reporting period to be disclosed or only those for the period during which related party relationship exists?

Solution

As per the definition of related parties in AS-18, the existence of a related party relationship should be identified at all points during the year (and not only at the close of the financial year). However, AS 18 requires disclosure of transactions with these parties only during the existence of the related party relationship.

LEASES

AS 19

INTRODUCTION

Meaning of Lease	✓ Lease means transfer of right to use assets for specified period against consideration/series of consideration.	
Parties in Lease	***Lessor***	✓ The party who transfers the asset is called 'Lessor'.
	Lessee	✓ The party to whom asset is transferred is called 'Lessee'.
Scope	*This Standard should be applied in accounting for all leases other than:* ✓ lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights ✓ licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights ✓ lease agreements to use lands	

TYPES OF LEASE

Finance Lease
A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred.
Deterministic Conditions: ***Atleast one of the following conditions must be satisfied to recognize the lease as Finance Lease***
→ Transfer of ownership of the asset to the lessee by the end of the lease term.
→ Where lessee has purchase option at very reduced rate & lessee is certain to opt for purchase at inception.
→ Where lease period covers substantial period of economic life of asset.
→ At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
→ The leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.
Suggestive Conditions: ***Even if all the conditions are met – It does not necessarily imply that it is a finance lease.***
→ If the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee
→ If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease);
→ If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.
Operating Lease
A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

SOME IMPORTANT TERMS

Minimum lease payments	✓ These are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with: ❖ in case of lessee, any residual value guaranteed by or on behalf of lessee or ❖ in the case of the lessor, any residual value guaranteed to the lessor: ▪ by or on behalf of the lessee ▪ by an independent third party financially capable of meeting this guarantee.
Fair Value	✓ It is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.
Economic Life	✓ Economic life is either: ❖ the period over which an asset is expected to be economically usable by one or more users or ❖ the number of production or similar units expected to be obtained from the asset by one or more users.
Useful life	✓ Useful life of a leased asset is either: ❖ the period over which leased asset is expected to be used by the lessee, or ❖ the number of production or similar units expected to be obtained from the use of the asset by the lessee.
Residual Value	✓ Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.
Guaranteed residual value	✓ GRV is : ❖ in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (amount of the guarantee being the maximum amount that could, in any event, become payable) and ❖ in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.
Unguaranteed residual value	✓ Unguaranteed residual value of leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.
Gross Investment	✓ Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.
Unearned finance income	✓ Unearned finance income is the difference between: ❖ the gross investment in the lease and ❖ the present value of ▪ the minimum lease payments under a finance lease from the standpoint of the lessor and ▪ any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.
Net investment	✓ Net investment is gross investment less unearned finance income.

The interest rate implicit on Lease	✓ The interest rate implicit on lease is the discount rate that, at the inception of the lease, causes the aggregate present value of ❖ the minimum lease payments under a finance lease from the standpoint of the lessor; and ❖ any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.
Lessee's incremental borrowing rate of interest	✓ It is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.
Contingent rent	✓ It is that portion of the lease payments that is not fixed in amount but is based on a factor other than just passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).
Initial Direct Costs	Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements such as commissions and legal fees ✓ **Lessee (Finance Lease)**: Included as part of the amount recognised as an asset under the lease. ✓ **Lessor (Finance Lease)**: Recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.
Non-Cancellable Lease	✓ a lease that is cancellable only: (a) upon the occurrence of some remote contingency; or (b) with the permission of the lessor; or (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain

FINANCE LEASE

FINANCIAL STATEMENTS OF LESSOR:

1. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.
2. The lessor should make the following disclosures for finance leases:
   a. a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
      i. not later than one year
      ii. later than one year and not later than five years
      iii. later than five years
   b. unearned finance income
   c. the unguaranteed residual values accruing to the benefit of the lessor
   d. the accumulated provision for uncollectible minimum lease payments receivable
   e. contingent rents recognised in the statement of profit and loss for the period
   f. a general description of the significant leasing arrangements of the lessor
   g. accounting policy adopted in respect of initial direct costs.

FINANCIAL STATEMENTS OF LESSEE:

1. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease or present value of the minimum lease payments from the standpoint of the lessee whichever is lower.
2. Useful Life for depreciation:
   a. Asset will be retained by the lessee: Useful Life
   b. Asset will be returned to the lessor: Useful life or lease term whichever is shorter
3. The lessee should, in addition to the requirements of AS 10, Property, Plant & Equipment and the governing statute, make the following disclosures for finance leases:
   a. assets acquired under finance lease as segregated from the assets owned
   b. for each class of assets, the net carrying amount at the balance sheet date
   c. a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
      i. not later than one year
      ii. later than one year and not later than five years;
      iii. later than five years
   d. contingent rents recognised as expense in statement of profit and loss for the period
   e. the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
   f. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
      i. the basis on which contingent rent payments are determined
      ii. the existence and terms of renewal or purchase options and escalation clauses
      iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

OPERATING LEASE

FINANCIAL STATEMENTS OF LESSOR:

1. The lessor should present an asset given under operating lease in its balance sheet under fixed assets. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished
2. The lessor should, in addition to the requirements of AS 10, Property, Plant & Equipment and the governing statute, make the following disclosures for operating leases:
   a. for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at balance sheet date; and depreciation recognised, impairment losses recognised/reversed in statement of profit and loss for the period
   b. the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:
      i. not later than one year
      ii. later than one year and not later than five years
      iii. later than five years
   c. total contingent rents recognised as income in statement of profit & loss for the period
   d. a general description of the lessor 's significant leasing arrangements
   e. accounting policy adopted in respect of initial direct costs.

FINANCIAL STATEMENTS OF LESSEE:

1. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.
2. The lessee should make the following disclosures for operating leases:
   a. the total of future minimum lease payments under non- cancellable operating leases for each of the following periods:
      i. not later than one year
      ii. later than one year and not later than five years
      iii. later than five years
   b. the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
   c. lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents
   d. sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period
   e. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
      i. the basis on which contingent rent payments are determined
      ii. the existence and terms of renewal or purchase options and escalation clauses
      iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

SALE AND LEASEBACK TRANSACTIONS

1. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.
2. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.
3. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately.
   a. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.
   b. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* Pg no._____

S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:

Lease Term	4 Years
Fair value at inception of lease	₹ 20,00,000
Lease Rent	₹ 6,25,000 p.a. at the end of year
Guaranteed residual value	₹ 1,25,000
Expected residual value	₹ 3,75,000
Implicit interest rate	15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively. Calculate the value of the lease liability as per AS-19 & finance charges of each year.

Question 2 *(ICAI Study Material)* Pg no._____

Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being ₹ 7,00,000. The economic life of machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays ₹ 3,00,000. The Lessee has guaranteed a residual value of ₹ 22,000 on expiry of the lease to the Lessor. However, Lessor Ltd., estimates that the residual value of the machinery will be only ₹ 15,000. The implicit rate of return is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.
Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year.

Question 3 *(RTP Nov 2018) / (RTP May 2020)* Pg no._____

ABC Ltd. took a machine on lease from XYZ Ltd., the fair value being ₹ 10,00,000. The economic life of the machine as well as the lease term is 4 years. At the end of each year, ABC Ltd. pays ₹ 3,50,000. The lessee has guaranteed a residual value of ₹ 50,000 on expiry of the lease to the lessor. However, XYZ Ltd. estimates that the residual value of the machinery will be ₹ 35,000 only. The implicit rate of return is 16% and PV factors at 16% for year 1, year 2, year 3 and year 4 are 0.8621, 0.7432, 0.6407 and 0.5523 respectively. You are required to calculate the value of machinery to be considered by ABC Ltd. and the finance charges for each year.

Question 4 *(ICAI Study Material) / (RTP Jan 2025) (Similar)* Pg no._____

Prakash Limited leased a machine to Badal Limited on the following terms:

Lease Term	5 Years
Fair value of Machine	₹ 28.3 Lakhs
Lease Rent per annum	₹ 8 Lakhs
Guaranteed residual value	₹ 1.60 Lakhs
Expected residual value	₹ 3 Lakhs
Internal Rate of Return	15%

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively. Ascertain Unearned Finance Income.

Question 5 Pg no._____

Jet Carriers Ltd. has initiated a lease for four years in respect of a vehicle costing ₹ 20,00,000 with expected useful life of 5 years. The asset would revert to the company under the lease agreement. The other information available in respect of lease agreement is:

1) The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at ₹ 2,50,000
2) The implicit rate of interest is 10%.
3) The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hand of Jet Carriers Ltd.

a) The annual lease payment.
b) The unearned finance income.
c) The segregation of finance income.

(a) PV Residual value for 4 years @ 10% is 0.683. (b) PV Factor for 4 years @ 10% is 3.16987.

Question 6 *(ICAI Study Material)* *Pg no.*_____

B&P Ltd. availed a lease from N&L Ltd. The conditions of the lease terms are as under:

a) Lease period is 3 years, in the beginning of the year 2019, for equipment costing ₹ 10,00,000 and has an expected useful life of 5 years
b) The Fair market value is also ₹ 10,00,000.
c) The property reverts back to the lessor on termination of the lease.
d) The unguaranteed residual value is estimated at ₹ 1,00,000 at the end of the year 2021.
e) 3 equal annual payments are made at the end of each year.

The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is ₹ 0.7513. The present value of annuity of ₹ 1 due at the end of 3rd year at 10% IRR is ₹ 2.4868. State whether the lease constitute finance lease & calculate unearned finance income. (Consider IRR = 10%.)

Question 7 *Pg no.*_____

What do you understand by the term "Interest rate implicit on lease"? Calculate the interest rate implicit on lease from the following details:

Annual lease rent	₹ 80,000 at the end of each year
Lease period	5 Years
Guaranteed residual value	₹ 40,000
Unguaranteed residual value	₹ 24,000
Fair value at the inception of lease	₹ 3,20,000

Discounted rates for the first 5 years are as below:

At 10% 0.909, 0.826, 0.751, 0.683, 0621
At 14% 0.877, 0.769, 0.675, 0.592, 0.519

Question 8 *(RTP May 2022) (Similar)* *Pg no.*_____

Classify the following into either operating lease or Finance lease:-

a) Ownership of the asset gets vested to the lessee at the end of lease term.
b) Lessee has option to purchase the asset at lower than fair value, at the end of lease term.
c) Economic life of the asset is 7 years, lease term is 6.5 years, but the asset is not acquired at the end of the lease term.
d) Present Value (PV) of Minimum Lease Payment (MLP) = 'X'. Fair value of the asset is 'Y'
e) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for the use of the lessee.

Question 9 *Pg no.*_____

Suppose outputs from machine taken on 3-year operating lease are estimated as 10,000 units in year 1, 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are ₹ 25,000, ₹ 45,000 and ₹ 50,000 respectively.

Pass entries in books of lessee for 3 years.

Question 10

*Pg no.*_____

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost ₹ 5,00,000. Straight-line depreciation in proportion of output is considered appropriate. Calculate lease rentals and pass entries in books of lessor for 1st year.

Question 11

*Pg no.*_____

On 1st January, 2020, Santa Ltd. sold equipment for ₹ 6,14,460. The carrying amount of the equipment on that date was ₹ 1,00,000. The sale was a part of the package under which Banta Ltd. leased the asset to Santa Ltd. for ten years term. The economic life of the asset is estimated as 10 years. The minimum lease rents payable by the lessee has been fixed at ₹ 1,00,000 payable annually beginning from 31st December, 2020. The incremental borrowing interest rate of Santa Ltd. is estimated at 10% p.a. Calculate the net effect on the Statement of profit and loss in the books of Santa Ltd.

Question 12 *(RTP Nov 2020) (May 2022) (Similar) / (ICAI Study Material)*

*Pg no.*_____

A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs & 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.

PRACTICE QUESTIONS

Question 1

*Pg no.*_____

Annual lease rent = ₹ 80,000 at the end of each year
Lease period = 5 years Guaranteed residual value = ₹ 28,000
Fair value at the inception (beginning) of lease = ₹ 3,00,000
Interest rate implicit on lease is 12.6%. The present value factors at 12.6% are 0.89, 0.79, 0.7, 0.622, 0.552 at the end of first, second, third, fourth and fifth year respectively.
Show the Journal entry to record the asset taken on finance lease in the books of the lessee.

Solution

Journal entry in the books of Lessee

Particulars	L.F.	Dr.	Cr.
Asset A/c Dr.		2,99,776	
To Lessor			2,99,776
(Being recognition of finance lease as an asset and a liability)			

Working Note:

Year	Lease Payments	Discounting Factor (12.6%)	Present Value
1	80,000	0.89	71,200
2	80,000	0.79	63,200
3	80,000	0.70	56,000
4	80,000	0.622	49,760
5	80,000	0.552	44,160
5	28,000 (GRV)	0.552	15,456
			2,99,776

Question 2 *(Inter May 2019) (5 Marks) / (RTP Nov 2023)*

*Pg no.*_____

Jaya Ltd. took a machine on lease from Deluxe Ltd., the fair value being ₹ 11,50,000. Economic life of the machine as well as lease term is 4 years. At the end of each year, lessee pays ₹ 3,50,000 to lessor. Jaya Ltd. has guaranteed a residual value of ₹ 70,000 on expiry of the lease to Deluxe Ltd., however Deluxe Ltd. estimates that residual value will be only ₹ 25,000. The implicit rate of return is 10% p.a. and present value factors at 10% are: 0.909, 0.826, 0.751 and 0.683 at the end of 1st, 2nd, 3rd and 4th year respectively. Calculate the value of machinery to be considered by Jaya Ltd. and the value of the lease liability as per AS-19.

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of lessee, the amount recorded as an asset and a liability should be present value of minimum lease payments from standpoint of lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Lease Payments	Discounting Factor (10%)	Present Value
1	3,50,000	0.909	3,18,150
2	3,50,000	0.826	2,89,100

3	3,50,000	0.751	2,62,850
4	4,20,000 (3,50,000+70,000 GRV)	0.683	2,86,860
			11,56,960

Present value of minimum lease payments ₹ 11,56,960 is more than fair value at the inception of lease i.e. ₹ 11,50,000, therefore, the lease liability and machinery should be recognized in the books at ₹ 11,50,000 as per AS 19.

Question 3

*Pg no.*_____

Sun Limited leased a machine to Moon Limited on the following terms:

Fair value at inception of lease	₹ 50,00,000
Lease Term	4 Years
Lease Rent per annum	₹ 16,00,000
Guaranteed residual value	₹ 3,00,000
Expected residual value	₹ 4,50,000
Implicit interest rate	15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively. Calculate the value of Lease Liability and ascertain Unearned Finance Income as per AS19

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Lease Payments	Discounting Factor (15%)	Present Value
1	16,00,000	0.8696	13,91,360
2	16,00,000	0.7561	12,09,760
3	16,00,000	0.6575	10,52,000
4	19,00,000 (16,00,000+3,00,000 GRV)	0.5718	10,86,420
			47,39,540

Present value of minimum lease payments i.e. ₹ 47,39,540 is less than fair value at the inception of lease i.e. ₹ 50,00,000, therefore, the value of lease is ₹ 47,39,540 and lease liability should be recognized in the books at ₹ 47,39,540 as per AS 19.

Calculation of Unearned Finance Income

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

(a) Gross investment in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.
Gross investment = Minimum lease payments + Unguaranteed residual value
= [Total lease rent + Guaranteed residual value(GRV)] + Unguaranteed residual value(URV)
= [(₹ 16,00,000 x 4 years) + ₹ 3,00,000] + ₹ 1,50,000 = ₹ 68,50,000

(b) Present value of minimum lease payment from Lessor's view point lease liability
₹ 47,39,540 + present value of (URV) unguaranteed residual value (₹ 1,50,000 x 0.5718)
= ₹ 48,25,310

Unearned Finance Income = (a) – (b) = ₹ 68,50,000 – ₹ 48,25,310= ₹ 20,24,690

Question 4 *(RTP May 2018)/ (RTP Nov 2022) / (RTP May 2023)* *Pg no._____*

WIN Ltd. has entered into a three-year lease arrangement with Tanya sports club in respect of Fitness Equipments costing ₹ 16,99,999.50. The annual lease payments to be made at the end of each year are structured in such a way that the sum of the Present Values of the lease payments and that of the residual value together equal the cost of the equipments leased out. The unguaranteed residual value of the equipment at the expiry of the lease is estimated to be ₹ 1,33,500. The assets would revert to the lessor at the end of the lease. Given that the implicit rate of interest is 10%. You are required to compute the amount of the annual lease payment and the unearned finance income. Discounting Factor at 10% for years 1, 2 and 3 are 0.909, 0.826 and 0.751 respectively.

Solution

Computation of annual lease payment to the lessor

Cost of equipment	16,99,999.50
Unguaranteed residual value	1,33,500
Present value of residual value after third year @ 10% (₹ 1,33,500 × 0.751)	1,00,258.50
Fair value to be recovered from lease payments (₹ 16,99,999.5– ₹ 1,00,258.5)	15,99,741
Present value of annuity for three years is 2.486	
Annual lease payment = ₹ 15,99,741/ 2.486	**6,43,500**

Computation of Unearned Finance Income

Total lease payments (₹ 6,43,500 x 3)	19,30,500
Add: Unguaranteed residual value	1,33,500
Gross investment in the lease	20,64,000
Less: Present value of investment (lease payments and residual value) (₹ 1,00,258.5+ ₹ 15,99,741)	(16,99,999.50)
Unearned finance income	**3,64,000.50**

Question 5 *Pg no._____*

X Ltd. has leased equipment over its useful life that costs ₹ 7,46,55,100 for a three year lease period. After the lease term the asset would revert to the Lessor. You are informed that:

(i) The estimated unguaranteed residual value would be ₹ 1 lakh only.

(ii) The annual lease payments have been structured in such a way that sum of their present values together with that of the residual value of the asset will equal the cost thereof.

(iii) Implicit interest rate is 10%. You are required to ascertain the annual lease payment and the unearned finance income. Annual lease payments are made at the end of each accounting year. P.V. factor @ 10% for years 1 to 3 are 0.909, 0.826 and 0.751 respectively

Solution

Computation of annual lease payment to the lessor

Cost of equipment	7,46,55,100
Unguaranteed residual value	1,00,000
Present value of residual value after third year @ 10% (₹ 1,00,000 × 0.751)	75,100

Fair value to be recovered from lease payments (₹ 7,46,55,100 – ₹ 75,100)	7,45,80,000
Present value of annuity for three years is 2.486	
Annual lease payment = ₹ 7,45,80,000/ 2.486	**3,00,00,000**

Computation of Unearned Finance Income

Total lease payments (₹ 3,00,00,000 x 3)	9,00,00,000
Add: Unguaranteed residual value	1,00,000
Gross investment in the lease	9,01,00,000
Less: Present value of investment (lease payments and residual value) (₹ 7,45,80,000+ ₹ 75,100)	(7,46,55,100)
Unearned finance income	**1,54,44,900**

Question 6 *(Inter May 2024) (4 Marks)* *Pg no._____*

Colour Limited leased a Machine to Red Limited on 1 April, 2021 on the following:

Cost of the machine	₹ 18,00,000
Lease term	3 Years
Fair market value of the machine	₹ 18,00,000
Unguaranteed residual value as on 31.3.2024	₹ 2,00,000
Internal rate of return	12%

Other information:

The expected useful life of the machine is 5 years. The machine will revert to Colour Limited on termination of the lease. The lease payment is to be made at the end of each year in 3 equal parts.

The present value of ₹ 1 due at the end of 3rd year at 12% rate of interest is ₹ 0.7118. The present value of annuity of at ₹ 1 due at the end of 3rd year at 12% IRR is ₹ 2.4018.

You are required to analyze whether lease constitutes finance lease. Also calculate unearned finance income, if any.

Solution

Computation of Annual Lease Payment

Particulars	Amount
Cost of Equipment	18,00,000
Unguaranteed Residual Value	2,00,000
Present Value of unguaranteed residual value (₹ 200,000 x 0.7118)	1,42,360
Present Value of Lease Payments (₹ 18,00,000 – ₹ 1,42,360)	16,57,640
Present Value of Annuity for three years is 2.4018	
Annual Lease Payment (16,57,640 / 2.4018)	6,90,165.71

Classification of Lease:

Parameter 1:

The present value of lease payment i.e. ₹ 16,57,649 which equals 92.09% of the fair market value i.e., ₹ 18,00,000.

The present value of minimum lease payments is substantially covers the fair value of the leased asset

Parameter 2:

The lease term (i.e. 3 years) covers the major part of the life of the asset (i.e. 5 years).

Therefore, it constitutes a finance lease.

Computation of unearned Finance Income:

Particulars	Amount
Total Lease Payments (₹ 6,90,165 x 3)	₹ 20,70,495
Add: Unguaranteed residual value	₹ 2,00,000
	₹ 22,70,495
Less: Present value of lease payments and residual value i.e. Net investment (1,42,360+16,57,640)	₹ 18,00,000
Unearned Finance Income	**₹ 4,70,495**

Question 7 *(Inter Jan 2025) (5 Marks)* *Pg no._____*

J Limited availed an equipment on lease from K Limited. The conditions of the lease terms are as under:

a) Lease starts from 1st April, 2020 for a period of 4 years and useful life of the equipment is 6 years. Both the cost and fair value of equipment are ₹ 12,50,000.
b) The equipment reverts back to the lessor on termination of the lease.
c) The unguaranteed residual value is estimated at ₹ 1,20,000 at the end of the financial year 2023-2024.
d) The amount will be paid in 4 equal instalments at the end of each year.
e) Consider IRR = 8%
f) The present value of 1 at the end of 4th year at 8% of interest is ₹ 0.735.
g) The present value of annuity of ₹ 1 due at the end of 4th year at 8% IRR is ₹ 3.312

State whether this lease is Operating lease or Finance lease (by applying two deterministic parameters). Also calculate unearned finance Income.

Solution

Computation of Annual Lease Payment

Particulars	Amount
Cost of Equipment	12,50,000
Unguaranteed Residual Value	1,20,000
Present Value of unguaranteed residual value (₹ 1,20,000 x 0.735)	88,200
Present Value of Lease Payments (₹ 12,50,000 – ₹ 88,200)	11,61,800
Present Value of Annuity for 4 years is 3.312	
Annual Lease Payment (11,61,800 / 3.312)	3,50,785.02

Classification of Lease:

Parameter 1:

The present value of lease payment i.e. ₹ 11,61,800 which equals 92.94% of the fair market value i.e., ₹ 12,50,000.

The present value of minimum lease payments is substantially covers the fair value of the leased asset

Parameter 2:

The lease term (i.e. 4 years) covers the major part of the life of the asset (i.e. 6 years).

Therefore, it constitutes a finance lease.

Computation of unearned Finance Income:

Particulars	Amount
Total Lease Payments (₹ 3,50,785 x 4)	₹ 14,03,140
Add: Unguaranteed residual value	₹ 1,20,000
	₹ 15,23,140
Less: Present value of lease payments and residual value i.e. Net investment (88,200 +11,61,800)	₹ 12,50,000
Unearned Finance Income	**₹ 2,73,140**

Question 8 *(RTP Nov 2019) / (RTP May 2021) / (RTP May 2024) (Similar)* *Pg no._____*

Sun Limited wishes to obtain a machine costing ₹30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Star Ltd., for a lease rental for₹3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advise. (Use annuity factor at @ 15% for 5 years as 3.36)

Solution

As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment amounts to at least substantially all of the fair value of leased asset.

In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as

Annuity factor (Year 1 to Year 5)	3.36 (approx.)
Present Value of Minimum Lease Payments (₹ 3 Lakh each year)	₹ 10.08 Lakhs (approx.)

Thus, present value of minimum lease payments is ₹10.08 lakhs and the fair value of the machine is ₹ 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore, lease agreement is an operating lease.

Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit

Question 9 *(RTP Nov 2020) (Similar) / (ICAI Study Material)* *Pg no._____*

Classify the following into either operating lease or Finance lease:-

a) Lessee has option to purchase the asset at lower than fair value, at the end of lease term.
b) Economic life of the asset is 7 years, lease term is 6 years, but the asset is not acquired at the end of the lease term.
c) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for the use of the lessee.
d) Present Value (PV) of Minimum Lease Payment (MLP) = 'X'. Fair value of the asset is 'Y'

Solution

a) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.
b) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.
c) Since the asset is procured only for the use of lessee, it is a finance lease.
d) The lease is a finance lease if X = Y, or where X substantially equals Y.

Question 10 *(Inter Nov 2019) (5 Marks)* *Pg no._____*

Classify the following into either operating lease or finance lease with reason:

(1) Economic life of asset is 10 years, lease term is 9 years, but asset is not acquired at end of lease term.
(2) Lessee has option to purchase the asset at lower than fair value at the end of lease term.
(3) Lease payments should be recognized as an expense in the statement of Profit & Loss of a lessee.

(4) Present Value (PV) of Minimum Lease Payment (MLP) = "X". Fair value of the asset is "Y". X = Y.
(5) Economic life of the asset is 5 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee.

Solution

(1) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.
(2) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.
(3) It is an operating lease under which lease payments are recognized as expense in the profit and loss account of lessee to have better matching between cost and revenue.
(4) The lease is a finance lease if X = Y, or where X substantially equals Y.
(5) Since the asset is of special nature and has been procured only for the use of lessee, it is a finance lease.

Question 11 *(ICAI Study Material)* *Pg no._____*

A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost ₹ 1,50,000. Economic life of the machine is 5 years and output from the machine are estimated as 40,000 units, 50,000 units, 60,000 units, 80,000 units and 70,000 units consecutively for 5 years.
Straight line depreciation in proportion of output is considered appropriate. Compute the following:
(i) Annual Lease Rent
(ii) Lease Rent income to be recognized in each operating year and
(iii) Depreciation for 3 years of lease

Solution

(i) Annual lease rent

Total lease rent

$$= 130\% \text{ of } ₹\ 1,50,000 \times \frac{\text{Output during lease period}}{\text{Total Output}}$$

= 130% of ₹ 1,50,000 x (40,000 +50,000+ 60,000)/(40,000 + 50,000 + 60,000 + 80,000 +70,000)
= 1,95,000 x 1,50,000 units/3,00,000 units = ₹ 97,500
Annual lease rent = ₹ 97,500 / 3 = ₹ 32,500

(ii) Lease rent Income to be recognized in each operating year

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 40 : 50 : 60.
Hence income recognised in years 1, 2 and 3 will be as:
Year 1 ₹ 26,000, Year 2 ₹ 32,500 and Year 3 ₹ 39,000.

(iii) Deprecation for three years of lease

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 1,50,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 40:50:60:80:70.
Depreciation for year 1 is ₹ 20,000, year 2 = 25,000 and year 3 = 30,000.

Question 12 *(Inter Dec 2021) (5 Marks)* *Pg no._____*

A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost of ₹ 2,25,000. Economic life of the machine is

5 years and output from the machine is estimated as 60,000 units, 75,000 units, 90,000 units, 1,20,000 units and 1,05,000 units consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate. You are required to compute the following as per AS-19.

a) Annual Lease Rent
b) Lease Rent income to be recognized in each operating year and
c) Depreciation for 3 years lease

Solution

a) **Annual lease rent**

Total lease rent = 130% of ₹ 2,25,000 × Output during lease period/ Total output
= 130% of 2,25,000x (60,000 +75,000+ 90,000)/(60,000 + 75,000 + 90,000 + 1,20,000 + 1,05,000)
= 2,92,500 x 2,25,000 units/4,50,000 units = ₹ 1,46,250
Annual lease rent = ₹ 1,46,250 / 3 = ₹ 48,750

b) **Lease rent Income to be recognized in each operating year**

Total lease rent should be recognized as income in proportion of output during lease period, i.e. in the proportion of 60,000 : 75,000 : 90,000 or 4:5:6
Hence income recognized in years 1, 2 and 3 will be as:
Year 1 ₹ 39,000, Year 2 ₹ 48,750 and Year 3 ₹ 58,500.

c) **Depreciation for three years of lease**

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 2,25,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 60 :75: 90 : 120 : 105 .
Depreciation for year 1 is ₹ 30,000, year 2 = 37,500 and year 3 = 45,000.

Question 13 *(Inter May 2018) (5 Marks)* *Pg no._____*

A Ltd. sold JCB having WDV of ₹ 20 lakhs to B Ltd. for ₹ 24 lakhs and the same JCB was leased back by B Ltd. to A Ltd. The lease is operating lease. In context of Accounting Standard 19 "Leases" explain the accounting treatment of profit or loss in the books of A Ltd. if

(i) Sale price of ₹ 24 lakhs is equal to fair value.
(ii) Fair value is ₹ 20 lakhs and sale price is ₹ 24 lakhs.
(iii) Fair value is ₹ 22 lakhs and sale price is ₹ 25 lakhs.
(iv) Fair value is ₹ 25 lakhs and sale price is ₹ 18 lakhs.
(v) Fair value is ₹ 18 lakhs and sale price is ₹ 19 lakhs

Solution

Following will be the treatment in the given cases:

(i) When sale price of ₹ 24 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of ₹4 lakhs (i.e. 24 – 20) in its books.
(ii) When fair value is ₹ 20 lakhs & sale price is ₹ 24 lakhs then profit of ₹ 4 lakhs is to be deferred and amortised over the lease period.
(iii) When fair value is ₹ 22 lakhs & sale price is ₹ 25 lakhs, profit of ₹ 2 lakhs (22 - 20) to be immediately recognised in its books and balance profit of ₹3 lakhs (25-22) is to be amortised/deferred over lease period.
(iv) When fair value of leased machinery is ₹ 25 lakhs & sale price is ₹ 18 lakhs, then loss of ₹ 2 lakhs (20 – 18) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment.
(v) When fair value is ₹ 18 lakhs & sale price is ₹ 19 lakhs, then the loss of ₹ 2 lakhs (20-18) to be immediately recognised by A Ltd. in its books and profit of ₹ 1 lakhs (19-18) should be amortised/deferred over lease period

Question 14 *(Inter Jan 2021) (5 Marks) / (ICAI Study Material)* *Pg no._____*

X Ltd. sold machinery having WDV of ₹ 300 lakhs to Y Ltd. for ₹ 400 lakhs and the same machinery was leased back by Y Ltd. to X Ltd. The lease back arrangement is operating lease. Give your comments in the following situations:

(i) Sale price of ₹ 400 lakhs is equal to fair value.
(ii) Fair value is ₹ 450 lakhs.
(iii) Fair value is ₹ 350 lakhs and the sale price is ₹ 250 lakhs.
(iv) Fair value is ₹ 300 lakhs and sale price is ₹ 400 lakhs.
(v) Fair value is ₹ 250 lakhs and sale price is ₹ 290 lakhs.

Solution

Following will be the treatment in the given cases:

(i) When sale price of ₹ 400 lakhs is equal to fair value, X Ltd. should immediately recognise the profit of ₹100 lakhs (i.e. 400 – 300) in its books.
(ii) When fair value is ₹ 450 lakhs then also profit of ₹100 lakhs should be immediately recognised by X Ltd.
(iii) When fair value of leased machinery is ₹ 350 lakhs & sales price is ₹ 250 lakhs, then loss of ₹ 50 lakhs (300 – 250) to be immediately recognised by X Ltd. in its books provided loss is not compensated by future lease payment.
(iv) When fair value is ₹ 300 lakhs & sales price is ₹ 400 lakhs then, profit of ₹ 100 lakhs is to be deferred and amortised over the lease period.
(v) When fair value is ₹ 250 lakhs & sales price is ₹ 290 lakhs, then the loss of ₹ 50 lakhs (300-250) to be immediately recognised by X Ltd. in its books and profit of ₹ 40 lakhs (290-250) should be amortised/deferred over lease period.

Question 15 *(Inter May 2022) (5 Marks)* *Pg no._____*

What are the disclosures requirements for operating leases by the lessee as per AS-19?

Solution

As per AS 19, lessees are required to make following disclosures for operating leases:

a) the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:
   (i) not later than one year;
   (ii) later than one year and not later than five years;
   (iii) later than five years;
b) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date;
c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;
d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;
e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
   (i) the basis on which contingent rent payments are determined;
   (ii) the existence and terms of renewal or purchase options and escalation clauses; and
   (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

EARNINGS PER SHARE

AS 20

Objective

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.

EPS is of 2 types

- Basic EPS
- Diluted EPS

Basic Earnings Per Share

Net profit (loss) attributable to equity shareholders
Weighted average number of equity shares outstanding during the period

Numerator: All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period

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

Particulars	Adjusted in the numerator
Tax expense (Current and Deferred Tax)	Yes
Exceptional items as per AS 5	Yes
Extraordinary items as per AS 5	Yes
Changes in Accounting estimates as per AS 5	Yes
Changes in Accounting Policy as per AS 5	Yes
Amount of preference dividends (a) Non-cumulative preference (b) Cumulative preference shares	 Yes – only if it has been provided in the books Yes – irrespective, whether or not dividends have been provided for in the books

Diluted Earnings Per Share

Adjusted net profit for the current year
Weighted average number of equity shares

Numerator: Net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses adjusted for taxes that will be saved on the conversion of the dilutive potential equity shares into equity shares.

Denominator: Number of equity shares should be the aggregate of the weighted average number of equity shares, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares.

A Potential Equity Share is a financial instrument or other contract that entitles, or may entitle its holder to equity shares.

When these potential equity shares will be considered as a part of the denominator:

Particulars	From which date	Till which date
Potential equity shares which were issued last year and not yet converted into equity shares in current year	Beginning of the year	End of the year
Potential equity shares which were issued last year and have been converted into equity shares in current year	Beginning of the year	End of the year (Till date of conversion as a potential equity share and after conversion both as a part of Basic & Diluted EPS)
Potential equity shares which were issued in current year & not yet converted into equity shares in current year	Date of issue	End of the year
Potential equity shares which were issued last year and have been cancelled or have lapsed in current year	Beginning of the year	Till the date of cancellation or when they lapse

DILUTIVE POTENTIAL EQUITY SHARES

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

Particulars	Remarks	Is it to be taken as a part of Diluted EPS or not?
Conversion to equity shares would decrease earnings per share or increase loss per share from continuing ordinary activities.	Dilutive	Yes
Conversion to equity shares would increase earnings per share or decrease loss per share from continuing ordinary activities.	Anti-dilutive	No

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).

Disclosure

An enterprise should disclose the following:

a) Where the statement of profit and loss includes extraordinary items (as defined is AS 5), basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense);

b) The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

c) The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

d) The nominal value of shares along with the earnings per share figures.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* Pg no._____

Date	Particulars			Balance
1st January	Balance at beginning of year	1800	-	1800
31st May	Issue of shares for cash	600	-	2400
1st November	Buy back of shares	-	300	2100

Calculate weighted number of shares.

Question 2 Pg no._____

From the following information relating to Y Ltd. Calculate Earnings Per Share (EPS):

Particulars	₹ (in crores)
Profit before V.R.S. payments but after depreciation	75.00
Depreciation	10.00
VRS payments	32.10
Provision for taxation	15.00
Paid up share capital (shares of ₹ 10 each fully paid)	93.00

Question 3 *(ICAI Study Material)* Pg no._____

Date	Particulars	No. of Shares	Face Value	Paid up Value
1st January	Balance at beginning of year	1800	₹ 10	₹ 10
31st October	Issue of shares	600	₹ 10	₹ 5

Calculate weighted number of shares.

Question 4 Pg no._____

In April, 2019 a Limited Company issued 1,20,000 equity shares of ₹ 100 each. ₹50 per share was called up on that date which was paid by all shareholders. The remaining ₹ 50 was called up on 1.9.2019. All shareholders paid the sum in September, 2019, except on shareholder having 24,000 shares. The net profit for the year ended 31.3.2020 is ₹ 2,64,000 after dividend on preference shares of ₹ 64,000.

Compute basic EPS for year ended 31.3.2020 as per AS 20.

Question 5 *(ICAI Study Material)* Pg no._____

Net profit for the year 2019	₹ 18,00,000
Net profit for the year 2020	₹ 60,00,000
No. of equity shares outstanding until 30th Sept 2020	20,00,000

Bonus issue 1st October 2020 was 2 equity shares for each equity share outstanding at 30th September, 2020. Calculate Basic Earnings Per Share.

Question 6 Pg no._____

(i) State how would you compute, based on AS-20, the weighted average number of equity shares in the following case:

Date	Particulars	No. of Shares
1st April,2019	Balance of equity shares	4,80,000
31st August,2019	Equity shares issued for cash	3,60,000
1st February,2020	Equity shares bought back	1,80,000
31st March,2020	Balance of equity shares	6,60,000

(ii) Compute adjusted earnings per share and basic EPS based on the following information:

Net profit 2018-19	₹ 11,40,000
Net profit 2019-20	₹ 22,50,000
No. of equity shares outstanding until 31st December, 2019	5,00,000

Bonus issue on 1st Jan,2020, 1 equity share for each equity share outstanding at 31st Dec, 2019.

Question 7 *(ICAI Study Material)* *Pg no._____*

X Ltd. supplied the following information. You are required to compute the basic earnings per share. (Accounting Year 01.01 to 31.12)

Net Profit For	₹
Year 2021	20,00,000
Year 2022	30,00,000

No of shares outstanding prior to right issue 10,00,000 shares.
Right issue : One new share for each four shares outstanding i.e. 2,50,000 shares.
: Right Issue price ₹ 20
: Last date to exercise right 31st March, 2022
Fair value of one equity share immediately prior to exercise of rights on 31.03.2022 is ₹ 25.

Question 8 *(Inter Nov 2023) (5 Marks)* *Pg no._____*

Sapphire Limited earned Net profit of ₹ 39,00,000 and ₹ 59,40,000 for the years 2021-22 & 2022-23 respectively. The following information were given for 2022-2023:
(i) The company declared Rights issue of two new shares for each five outstanding shares.
(ii) 4,00,000 shares were outstanding prior to Rights issue.
(iii) Rights issue price was ₹ 27.50 and the last date to exercise rights was 1st July, 2022.
(iv) Fair value of one equity share immediately prior to exercise of rights on 1st July, 2022 was ₹ 143.
You are required to Compute Basic Earnings Per Share as per AS-20:
1. for the year 2021-22, and
2. for the year 2022-23

Question 9 *(ICAI Study Material)* *Pg no._____*

Calculate Diluted EPS.

No. of equity shares outstanding	30,00,000
Basic earnings per share	5
No. of 12% convertible debentures of ₹ 100 each. Each debenture is convertible into 10 equity shares	50,000
Tax rate	30%

Question 10 *Pg no._____*

Calculate the diluted earnings per share from the following information:

Net profit for the current year	₹17,10,000
No. of equity shares outstanding	4,00,000
No. of 8% convertible debentures of ₹ 100 each. Each debenture is convertible into 10 equity shares	20,000
Interest expenses for the current year	₹ 1,20,000
Tax relating to interest expenses	30%

Question 11 *(ICAI Study Material)* *Pg no._____*

Net profit for the year 2020	₹ 12,00,000
Weighted avg. no. of equity shares outstanding during the year 2020	5,00,000 shares
Average fair value of one equity share during the year 2020	₹ 20.00

Weighted avg. no. of shares under option during the year 2020	1,00,000 shares
Exercise price for shares under option during the year 2020	₹ 15.00

Compute Basic and Diluted Earnings Per Share.

Question 12

*Pg no.*_____

Calculate Basic EPS & Diluted EPS for the year 2019-20

01/04/2019	Equity Shares	2,00,000 shares
	8% Convertible Debentures	₹ 3,00,000 (convertible into 50,000 equity shares)
	9% Convertible Preference Shares	₹ 4,00,000 (convertible into 1,000 equity shares)
01/07/2019	Shares Warrants Issues	10,000

Earnings ₹ 10 Lacs. Consider tax rate of 30%

Question 13 *(Inter Jan 2025) (5 Marks)*

*Pg no.*_____

XYZ Limited has provided you the following information as on 31st March, 2024:

Particulars	₹
Net profit (After Tax)	₹ 31,20,000
No of shares outstanding as on 31-03-2024 of ₹ 10 each	8,00,000
Average fair value of one equity share during the year 2023-24	₹ 25
Weighted average no. of shares under option during the year 2023-24	80,000
Exercise price for shares under option during the year 2023-24	₹ 20
12% Debentures of ₹ 100 each (Each debenture is convertible into 4 equity shares)	₹ 30,00,000
Tax rate	30%

The company issued one equity share as bonus for every 5 equity shares outstanding as on 1st October, 2023. It further issued 2,00,000 equity shares of ₹ 10 each as on 1st January, 2024. Financial Year of the company ends on 31st March each year.

You are required to calculate Basic and Diluted earnings per share as on 31st March, 2024 (round off your answer to 2 decimal places).

Question 14 *(RTP May 2021) / (ICAI Study Material)*

*Pg no.*_____

In the following list of shares issued, for the purpose of calculation of weighted average number of shares, from which date weight is to be considered:

a) Equity Shares issued in exchange of cash,
b) Equity Shares issued as a result of conversion of a debt instrument,
c) Equity Shares issued in exchange for the settlement of a liability of the enterprise,
d) Equity Shares issued for rendering of services to the enterprise,
e) Equity Shares issued in lieu of interest and/or principal of an other financial instrument,
f) Equity Shares issued as consideration for the acquisition of an asset other than in cash.

Also define Potential Equity Share.

Solution

The following dates should be considered for consideration of weights for the purpose of calculation of weighted average number of shares in the given situations:

a) Date of Cash receivable
b) Date of conversion
c) Date on which settlement becomes effective
d) When the services are rendered
e) Date when interest ceases to accrue
f) Date on which the acquisition is recognised.

A Potential Equity Share is a financial instrument or other contract that entitles, or may entitle its holder to equity shares.

Question 15 *(RTP Nov 2021)* *Pg no._____*

AB Limited is a company engaged in manufacturing industrial packaging equipment. As per the terms of an agreement entered with its debenture holders, the company is required to appropriate adequate portion of its profits to a specific reserve over the period of maturity of the debentures such that, at the redemption date, the reserve constitutes at least half the value of such debentures. As such appropriations are not available for distribution to the equity shareholders, AB Limited has excluded this from the numerator in the computation of Basic EPS. Is this treatment correct as per provisions of AS 20?

Solution

The appropriation made to such a mandatory reserve created for redemption of debentures would be included in the net profit attributable to equity shareholders for the computation of Basic EPS. AS 20 states that "For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period". With an emphasis on the phrase attributable to equity shareholders, it may be construed that such amounts appropriated to mandatory reserves, though not available for distribution as dividend, are still attributable to equity shareholders. Accordingly, these amounts should be included in the computation of Basic EPS. In view of this, the treatment made by the company is not correct.

Question 16 *(RTP May 2022) / (ICAI Study Material)* *Pg no._____*

a) Stock options have been granted by AB Limited to its employees and they vest equally over 5 years, i.e., 20 per cent at the end of each year from the date of grant. The options will vest only if the employee is still employed with the company at the end of the year. If the employee leaves the company during the vesting period, the options that have vested can be exercised, while the others would lapse. Currently, AB Limited includes only the vested options for calculating Diluted EPS. Should only completely vested options be included for computation of Diluted EPS? Is this in accordance with the provisions of AS 20? Explain.

b) X Limited during the year ended March 31, 2021, has income from continuing ordinary operations of ₹ 2,40,000, a loss from discontinuing operations of ₹ 3,60,000 and accordingly a net loss of ₹ 1,20,000. The Company has 1,000 equity shares and 200 potential equity shares outstanding as at March 31, 2021. You are required to compute Basic and Diluted EPS?

Solution

a) AS 20 states that "A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares". Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans are examples of potential equity shares. Further, for the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

The current method of calculating Diluted EPS adopted by AB limited is not in accordance with AS 20. The calculation of Diluted EPS should include all potential equity shares, i.e., all the stock options granted at the balance sheet date, which are dilutive in nature, irrespective of the vesting pattern. The options that have lapsed during the year should be included for the portion of the period the same were outstanding, pursuant to the requirement of the standard.

b) As per AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share or increase loss per share from continuing ordinary operations". As income from continuing ordinary operations, ₹ 2,40,000 would be considered and not ₹ (1,20,000), for ascertaining whether 200 potential equity shares are dilutive or anti-dilutive. Accordingly, 200 potential equity shares would be dilutive potential equity shares since their inclusion would decrease the net profit per share from continuing ordinary operations from ₹ 240 to ₹ 200.
Thus, the basic E.P.S would be ₹ (120) and diluted E.P.S. would be ₹ (100).

Question 17 *(RTP Jan 2025)* *Pg no.*_____

XYZ Limited has a wholly owned subsidiary BC Limited. The Group prepares consolidated Financial Statements for the year ended 31st March, 2024. XYZ Limited (in its separate financial statements) has incurred a loss of ₹ 2 crore during the year, while the consolidated profit for the group during the year is ₹ 40 lakh.
XYZ Limited has 5,00,000 shares outstanding as at 31st March, 2024. Further, it has granted options to issue equity shares as at that date. In respect of such options, 1,00,000 shares are considered to be the shares issued for no consideration. There are no changes in income or expenses that are expected from the issue of equity shares on exercise of these options.
Calculate Basic and Diluted EPS for XYZ Limited for separate financial statements and for the Group.

Solution

Computation of earnings per share

Particulars	Consolidated financial statements	Standalone financial statements of XYZ Limited
Basic earnings/ (loss) per share	₹ 8 [40,00,000/5,00,000]	(₹ 40) [2,00,00,000/5,00,000]
Diluted earnings/ (loss) per share	₹ 6.66 [40,00,000/ 6,00,000]	(₹ 40) [2,00,00,000/5,00,000]

As per paragraph 39 of AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.
In the above case, if the exercise of options was considered for separate financial statements of XYZ Limited, the diluted loss per share would have reduced to ₹ 33.33 [2,00,00,000/6,00,000]. As this is antidilutive, the options would not be treated as potentially dilutive equity shares. Accordingly, in the separate financial statements of XYZ Limited, the Diluted EPS would be same as Basic EPS.

PRACTICE QUESTIONS

Question 1

Pg no._____

Compute Basic Earnings per share from the following information:

Date	Particulars	No.of Shares
1st April, 2019	Balance at the beginning of the year	1500
1st August, 2019	Issue of shares for cash	600
31st March,2020	Buy back of shares	500

Net profit for the year ended 31st March, 2020 was ₹ 2,75,000.

Solution

Computation of weighted average number of shares outstanding during the period

Date	No.of Shares	Period Outstanding	Weighted average number of shares
1st April, 2019	1500	12 months	1,500*12/12 = 1,500
1st August, 2019	600	8 months	600*8/12 = 400
31st March, 2020	500	0 months	(500)*0/12 = (0)
			1,900

Basic Earnings per share (EPS) = Net profit attributable to equity shareholders / Weighted average number of equity shares O/s during year

= 2,75,000 / 1,900 Shares

= ₹ 144.74 per share

Question 2 *(Inter May 2018) (5 Marks) / (ICAI Study Material)*

Pg no._____

As at 1st April, 2019 a company had 6,00,000 equity shares of ₹ 10 each (₹ 5 paid up by all shareholders). On 1st September, 2019 the remaining ₹ 5 was called up and paid by all shareholders except one shareholder having 60,000 equity shares. The net profit for the year ended 31st March, 2020 was ₹ 21,96,000 after considering dividend on preference shares totalling to ₹ 3,40,000. Compute Basic EPS for the year ended 31st March, 2020 as per Accounting Standard 20 "Earnings Per Share".

Solution

Basic Earnings per share (EPS) = Net profit attributable to equity shareholders / Weighted average number of equity shares o/s during year

= 21,96,000 / 4,57,500 Shares (as per working note)

= ₹ 4.80 per share

Working Note:

Calculation of weighted average number of equity shares

As per AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated as follows:

Date	No. of Equity shares	Amount paid per share	Weighted average no. of equity shares
1.4.2019	6,00,000	5	6,00,000*5/10*5/12 = 1,25,000
1.9.2019	5,40,000	10	5,40,000*7/12 = 3,15,000
1.9.2019	60,000	5	60,000*5/10*7/12 = 17,500
Total shares			**4,57,500**

Alternative Presentation

Weighted Average Amount = (6,00,000*5)x12/12 +(5,40,000*5)x7/12
= 30,00,000 + 15,75,000
= 45,75,000

Weighted Average Shares = 45,75,000/10 = 4,57,500

Question 3

*Pg no.*_____

(i) Explain the concept of 'weighted average number of equity shares outstanding during the period'. Also compute weighted average no. of equity shares in the following case:

Date	Particulars	No. of Shares
1st April,2019	Balance of equity shares	7,20,000
31st August,2019	Equity shares issued for cash	2,40,000
1st February,2020	Equity shares bought back	1,20,000
31st March,2020	Balance of equity shares	8,40,000

(ii) Compute adjusted earnings per share and basic EPS based on the following information:

Net profit 2018-19	₹ 7,20,000
Net profit 2019-20	₹ 24,00,000
No. of equity shares outstanding until 31st December, 2019	8,00,000

Bonus issue on 1st Jan, 2020, 2 equity shares for each equity share o/s at 31st December, 2019.

Solution

(i) As per AS 20, "Earnings Per Share", the weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or less number of shares outstanding at any time. For the purpose of calculating basic earnings per share, the number of equity shares should be weighted average number of equity shares outstanding during the period.

Weighted average number of equity shares

7,20,000 X 5/12	3,00,000 shares
9,60,000 X 5/12	4,00,000 shares
8,40,000 X 2/12	1,40,000 shares
	8,40,000 shares

(ii) Earning per share

Basic EPS 2019-20 = ₹ 24,00,000/24,00,000 = ₹ 1

Adjusted EPS 2018-19 = ₹ 7,20,000/24,00,000 = ₹ 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2018-19, the earliest period reported.

Question 4 *(ICAI Study Material)*

*Pg no.*_____

From the following information compute Basic and Adjusted Earnings per share:

Net Profit for 2021	₹ 11 lakhs
Net Profit for 2022	₹ 15 lakhs
No. of shares before Rights Issue	5 Lakhs
Rights issue Ratio	One for Every 5 Held
Issue Price	₹ 15
Last Date of exercising Rights option	01-03-2022
Fair value of share before Rights Issue	₹ 21 per share

Solution

Computation of theoretical ex-rights fair value per share

= Fair value of o/s shares prior to right exercise + Total Amt. received from exercise of rights
Number of shares outstanding prior to exercise + number of shares issued in the exercise

= (21.00 x 5,00,000 shares) + (15.00 x 1,00,000 shares)
5,00,000 shares + 1,00,000 shares

Theoretical ex-rights fair value per share = ₹ 20.00
Paid Part in Right Issue = 1,00,000 * 15/20 = 75,000 shares
Bonus Part in Right Issue = 1,00,000 – 75,000 = 25,000 shares

Computation of earnings per share

	Year 2021	Year 2022
EPS for the year 2021 as originally reported: (₹ 11,00,000/5,00,000 shares)	₹ 2.20	
EPS for the year 2021 restated for rights issue: [₹ 11,00,000/ (5,00,000 shares + 25,000 shares)]	₹ 2.10	
EPS for the year 2022 including effects of rights issue 15,00,000 / {(5,00,000 + 25,000)*12/12}+ (75,000 x 10/12)		₹ 2.55

Alternatively : Computation of adjustment factor

Fair value per share prior to exercise of rights = 21.00 = 1.05
Theoretical ex - rights value per share 20.00

Computation of earnings per share

	Year 2021	Year 2022
EPS for the year 2021 as originally reported: (₹ 11,00,000/5,00,000 shares)	₹ 2.20	
EPS for the year 2021 restated for rights issue: [₹ 11,00,000/ (5,00,000 shares x 1.05)]	₹ 2.10	
EPS for the year 2022 including effects of rights issue 15,00,000 / (5,00,000 x 1.05 x 2/12)+ (6,00,000 x 10/12)		₹ 2.55

Question 5 *(RTP Nov 2023)* Pg no._____

Net Profit for 2021-22	30,00,000
Net Profit for 2022-23	50,00,000
No. of shares outstanding prior to Rights Issue	20,00,000 shares
Rights issue Ratio	One share for each five equity shares outstanding (i.e. 4,00,000 shares)
Rights Issue Price	₹ 20
Last day to exercise rights	1st June ,2022
Fair value of share before Rights Issue	₹ 26

Compute Basic EPS for FY 2021-22 , FY 2022-23 and restated EPS for FY 2021-22.

Solution

Computation of theoretical ex-rights fair value per share

= Fair value of o/s shares prior to right exercise + Total Amt. received from exercise of rights
Number of shares outstanding prior to exercise + number of shares issued in the exercise

= (26 x 20,00,000 shares) + (20 x 4,00,000 shares)
20,00,000 shares + 4,00,000 shares

Theoretical ex-rights fair value per share = ₹ 25

Paid Part in Right Issue = 4,00,000 * 20/25 = 3,20,000 shares
Bonus Part in Right Issue = 4,00,000 – 3,20,000 = 80,000 shares

Computation of earnings per share

	Year 21 – 22	Year 22 – 23
EPS for the year 21 - 22 as originally reported: (₹ 30,00,000/20,00,000 shares)	1.50	
EPS for the year 21 - 22 restated for rights issue: [₹ 30,00,000/(20,00,000 shares + 80,000 shares)]	1.44	
EPS for the year 22-23 including effects of rights issue 50,00,000 / {(20,00,000 + 80,000)*12/12}+ (3,20,000 x 10/12)		2.13

Question 6 *(Inter Nov 2019) (5 Marks) / (RTP May 2023) / (ICAI Study Material)* *Pg no._____*

Following information is supplied by K Ltd.:
Number of shares outstanding prior to right issue - 2,50,000 shares.
Right issue - two new share for each 5 outstanding shares (i.e. 1,00,000 new shares)
Right issue price – ₹ 98
Last date of exercising rights - 30-06-2019.
Fair value of one equity share immediately prior to exercise of right on 30-06-2019 is ₹ 102.
Net Profit to equity shareholders:
2018-2019 – ₹ 50,00,000 2019-2020 ₹ 75,00,000
You are required to calculate the basic earnings per share as per AS-20 Earnings per Share.

Solution

Computation of theoretical ex-rights fair value per share

= Fair value of o/s shares prior to right exercise + Total Amt. received from exercise of rights / Number of shares outstanding prior to exercise + number of shares issued in the exercise

= (102.00 x 2,50,000 shares) + (98.00 x 1,00,000 shares) / 2,50,000 shares + 1,00,000 shares

Theoretical ex-rights fair value per share = ₹ 100.86
Paid Part in Right Issue = 1,00,000 * 98/100.86 = 97,164 shares
Bonus Part in Right Issue = 1,00,000 – 97,164 = 2,836 shares

Computation of earnings per share

	Year 18 – 19	Year 19 – 20
EPS for the year 18 - 19 as originally reported: (₹ 50,00,000/2,50,000 shares)	20.00	
EPS for the year 18 - 19 restated for rights issue: [₹ 50,00,000/(2,50,000 shares + 2,836 shares)]	19.78	
EPS for the year 19-20 including effects of rights issue 75,00,000 / {(2,50,000 + 2,836)*12/12}+ (97,164 x 9/12)		23.03

Question 7 *(RTP Sep 2024)* *Pg no._____*

The following information is available in respect of High-end Ltd. for the accounting year 2022-2023 and 2023-2024:

Year 2022-23	22,00,000
Year 2023-24	30,00,000

No of shares outstanding prior to right issue 10,00,000 shares.
Right issue : One new share for each five shares outstanding i.e. 2,00,000 shares.
: Right Issue price ₹ 25
: Last date to exercise right 31st July, 2023

Fair value of one equity share immediately prior to exercise of rights on 31.07.2023 is ₹ 32.
You are required to compute, as per AS 20:
(i) Basic earnings per share for the year 2022-2023.
(ii) Restated basic earnings per share for the year 2022-20223 for right issue.
(iii) Basic earnings per share for the year 2023-2024.

Solution

Computation of theoretical ex-rights fair value per share

= Fair value of o/s shares prior to right exercise + Total Amt. received from exercise of rights
Number of shares outstanding prior to exercise + number of shares issued in the exercise

= (32 x 10,00,000 shares) + (25 x 2,00,000 shares)
10,00,000 shares + 2,00,000 shares

Theoretical ex-rights fair value per share = ₹ 30.83
Paid Part in Right Issue = 2,00,000 * 25/30.83 = 1,62,180 shares
Bonus Part in Right Issue = 2,00,000 – 1,62,180 = 37,820 shares

Computation of earnings per share

	Year 22 – 23	Year 23 – 24
EPS for the year 22 - 23 as originally reported: (₹ 22,00,000/10,00,000 shares)	2.20	
EPS for the year 22 - 23 restated for rights issue: [₹ 22,00,000/(10,00,000 shares + 37,820 shares)]	2.12	
EPS for the year 23-24 including effects of rights issue 30,00,000 / {(10,00,000 + 37,820)*12/12}+ (1,62,180 x 8/12)		2.62

Question 8 *(Inter May 2022) (5 Marks) / (ICAI Study Material)* *Pg no.*_____

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NAT, a listed entity, as on 1st April,2021 had the following capital structure:

	₹
10,00,000 Equity Shares having face value of ₹ 1 each	10,00,000
10,00,000 8% Preference Shares having face value of ₹ 10 each	1,00,00,000

During the year 2021-2022, the company had profit after tax of ₹ 90,00,000
On 1st January,2022, NAT made a bonus issue of one equity share for every 2 equity shares outstanding as at 31st December,2021.
On 1st January,2022, NAT issued 2,00,000 equity shares of ₹ 1 each at their full market price of ₹ 7.60 per share. NAT's shares were trading at ₹ 8.05 per share on 31st March,2022.
Further it has been provided that the basic earnings per share for the year ended 31st March, 2021 was previously reported at ₹ 62.30.
You are required to:
(i) Calculate the basic earnings per share to be reported in the financial statements of NAT for the year ended 31st March,2022 including the comparative figure, in accordance with AS-20 Earnings Per Share.
(ii) Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?

Solution

(i) Calculation of Basic Earnings per share for the year ended 31st March, 2022 including the comparative figure:
(a) Earnings for the year ended 31st March, 2021 = EPS x Number of shares outstanding during 2020-2021
= ₹ 62.30 x 10,00,000 equity shares = ₹ 6,23,00,000

(b) Adjusted Earnings per share after taking into consideration bonus issue

Adjusted Basic EPS = Earnings for the year 2020-2021 / Total outstanding shares +Bonus issue

= ₹ 6,23,00,000 / (10,00,000+ 5,00,000)

= ₹ 6,23,00,000 / 15,00,000 = ₹ 41.53 per share

(c) Basic EPS for the year 2021-2022

Basic EPS = (Total Earnings – Preference Shares Dividend) / (Total shares outstanding at the beginning + Bonus issue + weighted average of the shares issued in January, 2022)

= (₹ 90,00,000 – ₹ (1,00,00,000 x 8%) / (10,00,000 + 5,00,000 + (2,00,000 x 3/12))

= ₹ 82,00,000 / 15,50,000 shares = ₹ 5.29 per share

(ii) In case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2021, the earliest period reported. However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

Question 9 *(ICAI Study Material)* *Pg no._____*

Net profit for the current year	₹ 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	₹ 2
No. of 12% convertible debentures of ₹ 100 each. Each debenture is convertible into 10 equity shares	1,00,000
Interest expense for the current year	₹ 12,00,000
Tax relating to interest expense (30%)	₹ 3,60,000

Compute Diluted Earnings Per Share.

Solution

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

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

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

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

Question 10 *(RTP May 2018)* *Pg no._____*

Mohur Ltd. has equity capital of ₹ 40,00,000 consisting of fully paid equity shares of ₹ 10 each. The net profit for the year 2019-2020 was ₹ 60,00,000. It has also issued 36,000, 10% convertible debentures of ₹ 50 each. Each debenture is convertible into five equity shares. The tax rate applicable is 30%. You are required to compute the amount of diluted earnings for the year 2019-2020.

Solution

Adjusted net profit for the current year (60,00,000 + 1,80,000 – 54,000) = ₹ 61,26,000

No. of equity shares resulting from conversion of debentures: 36,000*5= 1,80,000 Shares

No. of equity shares used to compute diluted EPS: (4,00,000 + 1,80,000) = 5,80,000 Shares

Diluted earnings per share: (61,26,000/5,80,000) = ₹ 10.56

Question 11 *(Inter Nov 2018) (5 Marks)* *Pg no._____*

From following information given by Sampark Ltd, Calculate Basis & Diluted EPS as per AS20

	₹
Net Profit for the current year	2,50,00,000
No. of Equity Shares Outstanding	50,00,000
No. of 12% convertible debentures of ₹ 100 each	50,000
Each debenture is convertible into 8 Equity Shares	
Interest expense for the current year	6,00,000
Tax saving relating to interest expense (30%)	1,80,000

Solution

Calculation of Basic Earnings Per Share

Basic EPS = Net profit attributable to equity shareholders / Weighted average number of equity shares o/s during year

= 2,50,00,000 / 50,00,000 Shares

Basic EPS per share = ₹ 5

Calculation of Diluted Earnings Per Share

Diluted EPS= Adjusted net profit for the current year / Weighted average number of equity shares

Adjusted net profit for the current year	₹
Net profit for the current year	2,50,00,000
Add: Interest expenses for the current year	6,00,000
Less: Tax saving relating to Tax Expenses	(1,80,000)
	2,54,20,000

No. of equity shares resulting from conversion of debentures: 4,00,000 Shares

Weighted average no. of equity shares used to compute diluted EPS: (50,00,000 + 4,00,000) = 54,00,000 Equity Shares

Diluted earnings per share: (2,54,20,000/54,00,000) = ₹ 4.71 (Approx.)

Question 12 *(RTP May 2019)* *Pg no._____*

"While calculating diluted EPS, effect is given to all dilutive potential equity shares that were outstanding during that period." Explain this statement in the light of relevant AS.

Also calculate the diluted earnings per share from the following information:

Net profit for the current year (after tax)	₹1,00,00,000
No. of equity shares outstanding	10,00,000
No. of 10% convertible debentures of ₹ 100 each. (Each debenture is compulsorily & fully convertible into 10 equity shares)	1,00,000
Debenture interest expenses for the current year	₹ 5,00,000
Assume applicable income tax rate @ 30%	

Solution

"In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period." As per AS 20 'Earnings per Share', the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Computation of diluted earnings per share = Adjusted net profit for the current year / Weighted average number of equity shares

Net profit for the current year	1,00,00,000
Add: Interest expense for the current year	5,00,000
Less: Tax relating to interest expense (30% of ₹ 5,00,000)	(1,50,000)
Adjusted net profit for the current year	**1,03,50,000**

Note: Conversion of convertible debentures into Equity Share is a dilutive potential equity shares. Hence, to compute the adjusted profit the interest paid on such debentures will be added back as the same would not be payable in case these are converted into equity shares.

Weighted average number of equity shares

Number of equity shares resulting from conversion = (1,00,000 X 100)/10 = 10,00,000

Weighted average number of equity shares used to compute diluted earnings per share

= [(10,00,000 x 12) + (10,00,000 x 6*)]/12 = 15,00,000 shares

*Interest on debentures for full year amounts to ₹ 10,00,000 (i.e. 10% of ₹ 1,00,00,000). However, interest expense amounting ₹ 5,00,000 has been given in the question. It may be concluded that debentures have been issued during the year and interest has been provided for 6 months.

Diluted earnings per share = $\frac{1,03,50,000}{15,00,000 \text{ shares}}$ = ₹ 6.90 per share

Question 13 *(RTP May 2018/RTP Nov 2019 (Sim.)/RTP May 2020)/Nov 2022 (Similar)* *Pg no._____*

The following information relates to M/s. XYZ Limited for the year ended 31st March, 2020:

Net Profit for the year after tax: ₹ 75,00,000

Number of Equity Shares of ₹ 10 each outstanding: 10,00,000

Convertible Debentures Issued by the Company (at the beginning of the year)

Particulars	No.
8% Convertible Debentures of ₹ 100 each	1,00,000
Equity Shares to be issued on conversion	1,10,000

The Rate of Income Tax: 30%. Calculate Basic and Diluted Earnings Per Share (EPS).

Solution

Basic Earnings per share (EPS) = $\frac{\text{Net profit attributable to equity shareholders}}{\text{Weighted average no. of equity shares o/s during year}}$

= $\frac{75,00,000}{10,00,000 \text{ Shares}}$ = ₹ 7.5 per share

Computation of diluted earnings per share = $\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$

Net profit for the current year	75,00,000
Add: Interest expense for the current year	8,00,000
Less: Tax relating to interest expense (30% of ₹ 8,00,000)	(2,40,000)
Adjusted net profit for the current year	**80,60,000**

Number of equity shares resulting from conversion of deb. = 1,10,000 Equity shares (given)

Weighted average number of equity shares used to compute diluted earnings per share

= 11,10,000 shares (10,00,000 + 1,10,000)

Diluted earnings per share = $\frac{80,60,000}{11,10,000 \text{ shares}}$ = ₹ 7.26 per share

Question 14 *(Inter Dec 2021) (5 Marks)* *Pg no._____*

"At the time calculating diluted earnings per share, effect is given to all dilutive potential equity shares that are outstanding during the period". Comment and also calculate the basic and diluted earnings per share for the year 2020-21 from the following information:

Net profit after tax for the year	64,12,500
No. of equity shares outstanding	15,00,000
No. of 9% convertible debentures of ₹ 100 each issued on 1st July,2020	75,000
Each debenture is convertible into 8 equity shares	
Tax relating to interest expense	35%

Solution

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period." As per AS 20 'Earnings per Share', the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding* during the period should be adjusted for the effects of all dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Basic EPS for the year 2020-21= 64,12,500/15,00,000 = ₹ 4.275 or ₹ 4.28

Computation of diluted earnings per share = Adjusted net profit for the current year / Weighted average number of equity shares

Adjusted net profit for the current year will be (64,12,500 + 5,06,250 – 1,77,188) = ₹ 67,41,562

No. of equity shares resulting from conversion of debentures: 6,00,000 Shares (75,000 × 8)

Weighted average no. of equity shares used to compute diluted EPS: (15,00,000 X12/12+ 6,00,000X9/12) = 19,50,000 Shares

Diluted earnings per share: (67,41,562/19,50,000) = ₹ 3.46

Working Note:

Interest expense for 9 months = 75,00,000×9%×9/12 =₹ 5,06,250

Tax expense 35 % on interest is ₹1,77,188 (5,06,250 x 35%)

Question 15 *(Inter May 2024) (4 Marks)* Pg no._____

On 1 April 2023, ABC Limited has given the following information:

	₹
50,000 equity shares of ₹ 100 each (₹ 80 paid up by all shareholders)	40,00,000
2,00,000 8% Preference shares of ₹ 10 each	20,00,000
10,000, 12% Debentures of ₹ 100 each (Each debenture is convertible into 3 equity shares of ₹ 100 each)	10,00,000

On 1" July 2023, the remaining ₹ 20 was called up and paid by all the shareholders except one shareholder holding 10,000 equity shares. During the year 2023-24 the company had a profit after tax of ₹ 3,44,000.

Tax rate is 30%.

You are required to compute Basic and Diluted EPS.

Solution

Basic Earnings per share (EPS)

$$= \frac{\text{Net profit attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$$

$$= \frac{1,84,000}{46,000 \text{ Shares (as per working note)}} = ₹ 4 \text{ per share}$$

Diluted earnings per share

Net profit for the current year	₹ 3,44,000
No. of equity shares outstanding	50,000
Basic earnings per share	₹ 4
No. of 12% convertible debentures of ₹ 100 each Each debenture is convertible into 3 equity shares	10,000

Interest expense for the current year	₹ 1,20,000
Tax relating to interest expense (30%)	₹ 36,000
Adjusted net profit for the current year	₹ (1,84,000 + 1,20,000 – 36,000) = ₹ 2,68,000
No. of equity shares resulting from conversion of debentures	30,000
No. of equity shares used to compute diluted earnings per share	46,000 + 30,000 = 76,000
Diluted earnings per share	2,68,000 / 76,000 = ₹ 3.53

Working Note:

1. **Net profit attributable to equity share holders = Net profit less preference dividends**

   Total earnings – preference shares dividend

   ₹ 3,44,000 – ₹ (8% x 20,00,000)

   ₹ 3,44,000 - ₹ 1,60,000

   = ₹ 1,84,000

2. **Calculation of weighted average number of equity shares**

   As per AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated as follows:

Date	No. of equity shares	Amount paid per share	Weighted average no. of equity shares
01.04.2023	50,000	80	50,000 x 80/100 x 3/12 = 10,000
01.07.2023	40,000	100	40,000 x 9/12 = 30,000
01.07.2023	10,000	80	10,000x 80/100 x 9/12 = 6,000
Total weighted average equity shares			**46,000**

Alternative Presentation

Weighted Average Amount = (50,000*80)x12/12 +(40,000*20)x9/12

= 40,00,000 + 6,00,000

= 46,00,000

Weighted Average Shares = 46,00,000/100 = 46,000

Question 16 *(Inter Nov 2022) (5 Marks)* *Pg no._____*

The following information is provided to you:

Net profit for the year 2022:	₹72,00,000
Weighted average number of equity shares outstanding during the year 2022:	30,00,000 shares
Average Fair value of one equity share during the year 2022:	₹ 25.00
Weighted average number of shares under option during the year 2022:	6,00,000 shares
Exercise price for shares under option during the year 2022:	₹ 20.00

You are required to compute Basic and Diluted Earnings Per Share as per AS 20.

Solution

Computation of Basic earnings per share

	Earnings	Shares	Earnings/ Share
Net profit for the year 2022	72,00,000		
Weighted average no. of shares during year 2022		30,00,000	
Basic earnings per share (72,00,000/30,00,000)			2.40

Computation of Diluted earnings per share

	Earnings	Shares	Earnings/Share
Net profit for the year 2022	72,00,000		
Weighted average no. of shares during year 2022		30,00,000	
Number of shares under option		6,00,000	
Number of shares that would have been issued at fair value (6,00,000 x 20.00)/25.00		(4,80,000)	
Diluted earnings per share	72,00,000	31,20,000	2.31 (rounded-off)

Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (1,20,000) deemed for the purpose of the computation to have been issued for no consideration. To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of options.

Question 17

Pg no._____

For Accounting year 1-4-2019 to 31-3-2020

Net profit attributable to equity shareholders	1,00,00,000
No. of equity shares outstanding	20,00,000
Average fair value of one equity share during the year	75

Potential Equity Shares	
Options	1,00,000 with exercise price of ₹ 60
Convertible Preference Shares	8,00,000 shares entitled to cumulative dividend of ₹8 per share. Each preference share is convertible into 2 equity shares
12% Convertible Debentures of ₹ 100 each	Nominal amount ₹ 10,00,00,000. Each debenture is convertible into 4 equity shares.
Tax rate	30%

Calculate diluted earnings per share as per AS 20.

Solution

Incremental Earnings per share (IEPS) = $\frac{\text{Increase in Earnings}}{\text{Increase in number of equity shares}}$

(1) Options

IEPS = $\frac{\text{Nil}}{\text{20,000 Shares*}}$ = Nil

1,00,000(75-60)/75 = 20,000

(2) Convertible Preference Shares

IEPS = $\frac{(8*8,00,000)}{(2*8,00,000)} = \frac{64,00,000}{16,00,000} = 4$

(3) Convertible Debentures

IEPS = $\frac{(10,00,00,000)*12\%*(1-0.30)}{(4*10,00,000)}$

= $\frac{84,00,000}{40,00,000} = 2.10$

It may be noted from the above that options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered.

Conversion of Diluted Earnings Per Share

	Net Profit Attributable	No. of Equity Shares	Earnings per Share	
As reported	1,00,00,000	20,00,000	5	
Options	-	20,000		
	1,00,00,000	**20,20,000**	**4.95**	Dilutive
12% Convertible Debentures	84,00,000	40,00,000		
	1,84,00,000	**60,20,000**	**3.06**	Dilutive
Convertible Preference Shares	64,00,000	16,00,000		
	2,48,00,000	**76,20,000**	**3.25**	Anti Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from ₹ 3.06 to ₹ 3.25), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share is ₹ 3.06.

ACCOUNTING FOR TAXES ON INCOME

AS 22

Scope	This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. This includes determination of the amount of the expense or saving related to taxes on income in respect of an accounting period & disclosure of such an amount in the financial statements. The differences between taxable income and accounting income can be classified into permanent differences and timing differences	
Definitions	**Accounting income (loss)**	Net profit or loss for a period, as reported in the statement of profit and loss, before deducting income-tax expense or adding income tax saving.
	Taxable income (tax loss)	Amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income-tax payable (recoverable) is determined.
	Tax expense (tax saving)	Aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period
	Current tax	Amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.
	Deferred tax	Tax effect of timing differences.
	Timing differences	Differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.
	Permanent differences	Differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently
Recognition	❖ Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of net profit or loss for the period. ❖ Permanent differences do not result in deferred tax assets or deferred tax liabilities. ❖ Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. ❖ The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet.	
Deferred Tax Assets	❖ While recognizing the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation.	

	❖ This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future. ❖ Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, ***deferred tax assets should be recognised*** only to the extent that there is ***virtual certainty supported by convincing evidence*** that sufficient future taxable income will be available against which such deferred tax assets can be realised.	
Re-Assessment of Unrecognized Deferred Tax Assets	At each balance sheet date, an enterprise re-assesses unrecognized deferred tax assets. The enterprise recognizes previously unrecognized deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realized	
Measurement	➢ Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws. ➢ Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted by the balance sheet date. ➢ However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws. ➢ Deferred tax assets and liabilities should not be discounted to their present value.	
Disclosure	**Statement of profit & loss**	Under AS 22, there is no specific requirement to disclose current tax and deferred tax in the statement of profit and loss. However, considering the requirements under the Companies Act, 2013, the amount of income tax and other taxes on profits should be disclosed.
	Balance sheet	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.
Accounting for Taxes on Income in the situations of Tax Holiday	❖ The deferred tax in respect of timing differences which reverse during the tax holiday period should not be recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of the Act. ❖ Deferred tax in respect of timing differences which reverse after the tax holiday period should be recognised in the year in which the timing differences originate. ❖ However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22. For the above purposes, the timing differences which originate first should be considered to reverse first	

ASSIGNMENT QUESTIONS

Question 1 *(RTP Jan 2025)* Pg no._____

ABC Ltd. prepares its accounts annually on 31st March. On 1st April, 2022, it purchases a machine at a cost of ₹ 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of ₹ 2,00,000 each year and corporate tax rate is 40% each year.

The purchase of machine at a cost of ₹ 1,50,000 in 2022 gives rise to a tax saving of ₹ 60,000. The corporate tax rate has been assumed to be same in each of the three years.

Calculate deferred tax and pass necessary journal entries.

What will be the amount of deferred tax, if the substantively enacted tax rates for 2022, 2023 and 2024 are 40%, 35% and 38% respectively.

Question 2 *(ICAI Study Material)* Pg no._____

Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognizes revenue from these contracts on percentage of completion method for financial statements during 2017-2018, 2018-2019 and 2019-2020 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 years 2017-2018, 2018-2019 and 2019-2020 respectively. Income-tax rate 35%.

Compute the amount of deferred tax asset/ liability for the years 2017-2018, 2018-2019 and 2019-2020.

Question 3 *(RTP May 2018) / (ICAI Study Material)* Pg no._____

Rama Ltd., has provided the following information:

Depreciation as per accounting records	2,00,000
Depreciation as per income tax records	5,00,000
Unamortised preliminary expenses as per tax record	30,000

There is adequate evidence of future profit sufficiency. How much deferred tax asset/ liability should be recognised as transition adjustment? Tax rate 50%

Question 4 *(RTP May 2020)* Pg no._____

The following particulars are stated in the Balance Sheet of PQR Ltd. as on 31.03.2019

	(₹ In Lakhs)
Deferred Tax Liability (Cr.)	30.00
Deferred Tax Assets (Dr.)	15.00

The following transactions were reported during the year 2019-20

(i)	Tax Rate	30%
		(₹ In Lakhs)
(ii)	Depreciation as per Books	80.00
	Depreciation for tax purposes	70.00
(iii)	Items disallowed in 2018-19 & allowed for tax purposes in 2019-20	10.00
(iv)	Donations to Private Trusts made in 2019-20	10.00

There were no additions to Fixed Assets during the year. You are required to show the impact of various items on Deferred Tax Assets and Deferred Tax Liability as on 31.03.2020.

Question 5 *(Inter Nov 2023) (5 Marks)* *Pg no._____*

The following particulars are stated in Balance Sheet of Siddhi Limited as on 31st March, 2022:

Particulars	(₹ In lakhs)
Deferred Tax Liabilities (Cr.)	2.50
Deferred Tax Assets (Dr.)	1.35

The following transactions were reported during the year 2022-23:

(₹ in Lakhs)

(i)	Depreciation as per accounting records	15.00
(ii)	Depreciation as per income tax records	20.00
(iii)	Interest paid to NBFC accounted in books on accrual basis but paid on 30-06-2023	6.00
(iv)	Items disallowed for tax purposes in 2021-22 but allowed in 2022-23	1.05
(v)	Donation to Private Trust	40.00
(vi)	Tax rate	15%
(vii)	There were no additions to fixed assets during the year	

You are required to calculate the Deferred Tax Asset and Deferred Tax Liability as on 31st March 2023 as per AS-22.

Solution

Balances of Deferred tax assets and Deferred tax liability as on 31st March, 2023

	₹ (in lakhs)
Deferred tax liability (Cr.) (2.5 +.75)	3.25
Deferred tax asset (Dr.) (1.35 - .158*)	1.192

Working Note:

Impact of various items in terms of deferred tax liability / deferred tax asset

S. No.	Transactions	Nature of difference	Effect	Amount (₹)
(i), (ii)	Difference in depreciation	Timing difference	Creation of DTL	(20 - 15) x 15% = .75 lakh
(iii)	Interest to financial institutions	No timing difference	Not applicable	Not applicable
(iv)	Disallowances, as per IT Act, of earlier years	Timing difference	Reversalof DTA	₹ 1.05 lakh x 15% = ₹ .158* lakh
(v)	Donation to private trusts	Permanent difference	Not applicable	Not applicable

*Alternatively, may be rounded off as ₹ 0.157 lakh or 0.1575 lakh

Question 6 *(RTP May 2021)* *Pg no._____*

The following information is furnished in respect of Slate Ltd. for the year ending 31-3-2019:

(i) Depreciation as per books ₹ 2,80,000
Depreciation for tax purpose ₹ 1,90,000
The above depreciation does not include depreciation on new additions.

(ii) A new machinery purchased on 1.4.18 costing ₹ 1,20,000 on which 100% depreciation is allowed in the 1st year for tax purpose whereas Straight-line method is considered appropriate for accounting purpose with a life estimation of 4 years.

(iii) The company has made a profit of ₹ 6,40,000 before depreciation and taxes.

(iv) Corporate tax rate of 40%.

Prepare relevant extract of statement of Profit and Loss for the year ending 31-3-2019 and also show the effect of above items on deferred tax liability/asset as per AS 22

Question 7 - *(ICAI Study Material)* *Pg no._____*

ABC Company Ltd. had an investment in Venture Capital amounting 10 Crores. Venture capital in turn had invested in the below portfolio companies (New Start-ups) on behalf of ABC Ltd:

Portfolio Companies	Amount of investment (₹ in Crores)
Oscar Limited	2
Zee Limited	3
Star Limited	4
Sony Limited	1
Total	**10**

During the FY 2019-2020, Venture Capital had sold their investment in Star Limited and realised an amount of ₹ 8 Crores on sale of shares of star Limited and entire proceeds of ₹ 8 Crores have been transferred by Venture Capital to ABC Company Limited.

The accounts manager has received the following additional information from venture capital on 31.03.2020:

(1) ₹8 Crores has been deducted from the cost of investment and carrying amount of investment as at year end is ₹ 2 Crores.

(2) Company had to pay a capital gain tax @ 20% on the net sale consideration of ₹ 4 Crores.

(3) Due to COVID-19, the remaining start- ups (i.e. Oscar Limited, Zee Limited, and Sony Limited) are not performing well and will soon wind up their operations. Venture capital is monitoring the situation and if required they will provide an impairment loss in June 2020 Quarter.

You need to suggest the accounts manager what should be the correct accounting treatment as per AS 22 "Accounting for Taxes on Income

Solution

As company had to pay capital gain tax @ 20% on the net sale consideration as per income tax laws, the company has to recognise a current tax liability of 0.8 Crores computed as under:

Particulars	Amount (crores)
Sales Consideration	8
Cost of Investment	4
Net gain on Sale	4
Tax @ 20%	0.8

Timing differences are those differences between taxable income & accounting income for a period that originate in one period & are capable of reversal in one or more subsequent period

Particulars	Amount (crores)	Rationale
Taxable Income	4	As per income tax laws
Accounting Income	Nil	As the same is deducted from the cost of investment
Timing Difference	4	

As per AS 22, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Since in current scenario, due to Covid 19 the portfolio companies are not performing well, thus the company may not have sufficient future taxable income which will reverse deferred tax assets. Therefore, the company should not recognise DTA of ₹ 0.8 Crores and company should recognise only current tax liability of ₹ 0.8 Crores.

Question 8 *(ICAI Study Material)* *Pg no._____*

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of ₹ 2,00,000 for the year ending 31.3.2018. For the years ending 31.3.2019 and 31.3.2020, it made profits of ₹ 1,00,000 and ₹ 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.2018, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 2019 and 2020 for tax purposes. Prepare a statement of Profit and Loss for the years ending 2018, 2019 and 2020

Question 9 *(RTP Nov 2018)* *Pg no._____*

Beta Ltd. is a full tax-free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference is ₹ 1,000 lakhs and ₹ 2,000 lakhs respectively which will result in a tax liability in year 1 and 2. From the third year it is expected that the timing difference would reverse each year by ₹ 50 lakhs. Assuming tax rate of 40%, you are required to compute to the deferred tax liability at the end of the second year and any charge to the Profit and Loss account

Solution

As per AS 22, Accounting for Taxes on Income", deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognized to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income-tax Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognized in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of ₹ 1,000 lakhs depreciation, timing difference amounting ₹ 400 lakhs (₹ 50 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognized. However, for ₹ 600 lakhs (₹ 1,000 lakhs – ₹ 400 lakhs), deferred tax liability will be recognized for ₹ 240 lakhs (40% of ₹ 600 lakhs) in first year. In the second year, the entire amount of timing difference of ₹ 2,000 lakhs will reverse only after-tax holiday period and hence, will be recognized in full. Deferred tax liability amounting ₹ 800 lakhs (40% of ₹ 2,000 lakhs) will be created by charging it to profit and loss account and the total balance of deferred tax liability account at the end of second year will be ₹ 1,040 lakhs (240 lakhs + 800 lakhs).

Question 10 - *(ICAI Study Material)* *Pg no._____*

From the following details of A Ltd. for the year ended 31-03-2020, calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Particulars	₹
Accounting Profit	6,00,000
Book Profit as per MAT	3,50,000
Profit as per Income Tax Act	60,000
Tax Rate	20%
MAT Rate	7.50%

PRACTICE QUESTIONS

Question 1 *(Inter May 2019) (5 Marks) / (RTP Nov 2020) / (ICAI Study Material)* Pg no._____

Write short note on Timing differences and Permanent differences as per AS 22.

Solution

In current practices, companies, in general, prepare books of accounts as per Companies Act, 2013 generating Accounting Profit/Loss and Income-tax Act, 1961 generating Taxable Profit/Loss. Accounting income and taxable income for a period are seldom the same.

Permanent differences are the differences between taxable income and accounting income which arise in one accounting period and do not reverse subsequently. For example, an income exempt from tax or an expense that is not allowable as a deduction for tax purposes.

Timing differences are those differences between taxable income and accounting income which arise in one accounting period and are capable of reversal in one or more subsequent periods. For e.g., Depreciation, Bonus, etc.

Question 2 *(Inter May 2018) (5 Marks)* Pg no._____

Rohit Ltd. has provided the following information:

Particulars	Amount
Depreciation as per accounting records	2,50,000
Depreciation as per tax records	5,50,000
Unamortised preliminary expenses as per tax record	40,000

There is adequate evidence of future profit sufficiency. How much deferred tax assets/liability should be recognized as transition adjustment when the tax rate is 50%?

Solution

Table showing calculation of deferred tax asset / liability

Particulars	Amount	Timing Difference	Deferred Tax	Amount @ 50%
Excess depreciation as per tax records (5,50,000 – 2,50,000)	3,00,000	Timing	Deferred Tax Liability	1,50,000
Unamortised preliminary expenses as per tax records	40,000	Timing	Deferred Tax Asset	20,000
Net deferred tax liability				**1,30,000**

Net deferred tax liability amounting ₹ 1,30,000 should be recognized as transition adjustment.

Question 3 *(RTP Nov 2020)* Pg no._____

Rama Ltd. has provided the following information:

Particulars	Amount
Depreciation as per accounting records	6,00,000
Depreciation as per tax records	10,00,000
Unamortised preliminary expenses as per tax record	60,000

There is adequate evidence of future profit sufficiency.

You are required to calculate the amount of deferred tax asset/liability to be recognized as transition adjustment assuming tax rate as 30%?

Solution

Table showing calculation of deferred tax asset / liability

Particulars	Amount	Timing Difference	Deferred Tax	Amount @ 30%
Excess depreciation as per tax records (₹ 10,00,000 – ₹ 6,00,000)	4,00,000	Timing	Deferred Tax Liability	1,20,000
Unamortised preliminary expenses as per tax records	60,000	Timing	Deferred Tax Asset	18,000
Net deferred tax liability				**1,02,000**

Net deferred tax liability amounting 1,02,000 should be recognized as transition adjustment.

Question 4 *(Inter Jan 2021) (5 Marks)* *Pg no._____*

The following particulars are stated in the Balance Sheet of HS Ltd. as on 31.03.2019

	(₹ In Lakhs)
Deferred Tax Liability (Cr.)	60.00
Deferred Tax Assets (Dr.)	30.00

The following transactions were reported during the year 2019-20

(i)	Tax Rate	30%
		(₹ In Lakhs)
(ii)	Depreciation as per accounting records	160.00
	Depreciation as per income tax records	140.00
(iii)	Items disallowed in 2018-19 & allowed for tax purposes in 2019-20	20.00
(iv)	Donations to Private Trusts	20.00

There were no additions to Fixed Assets during the year. You are required to show the impact of various items on Deferred Tax Assets & Deferred Tax Liability as on 31.03.20 as per AS 22.

Solution

Impact of various items in terms of AS 22 deferred tax liability/deferred tax asset

(1) **Difference in Depreciation**- Generally, written down value method of depreciation is adopted under income Tax Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years. It is timing difference for which reversal of Deferred tax liability is required.
Reversal of DTL= (160 – 140) Lakhs X 30% = 6 Lakhs

(2) **Disallowances, as per IT Act of earlier years**- Due to disallowance tax payable for the earlier years was higher on this account. It is responding timing difference which required Reversal of Deferred tax assets.
Reversal of Deferred tax assets = 20 Lakhs X 30% = 6 Lakhs

(3) **Donations to private trusts** is not an allowable expenditure under IT Act. It is permanent difference. Hence, no reversal of tax is required

Question 5 *(Inter July 2021) (5 Marks)* *Pg no._____*

Following particulars are stated in the Balance Sheet of Deep Limited as on 31st March, 2020:

	(₹ In Lakhs)
Deferred Tax Liability (Cr.)	28.00
Deferred Tax Assets (Dr.)	14.00

The following transactions were reported during the year 2020 -2021:

(i) Depreciation as per books was ₹ 70 Lakhs whereas Depreciation for Tax purposes was ₹ 42 Lakhs. There were no additions to Fixed Assets during the year.

(ii) Expenses disallowed in 2019-20 and allowed for tax purposes in 2020-21 were ₹ 14 Lakhs.
(iii) Share issue expenses allowed under section 35(D) of the Income Tax Act, 1961 for the year 2020-21 (1/10th of ₹ 70.00 lakhs incurred in 2019-20).
(iv) Repairs to Plant and Machinery were made during the year for ₹ 140.00 Lakhs and was spread over the period 2020-21 and 2021-22 equally in the books. However, the entire expenditure was allowed for income-tax purposes in the year 2020-21.

Tax Rate to be taken at 40%.

You are required to show the impact of above items on Deferred Tax Assets and Deferred Tax Liability as on 31st March, 2021.

Solution

Impact of various items in terms of deferred tax liability/deferred tax asset on 31.3.21

Transactions	Analysis	Nature of difference	Effect	Amount (₹)
Difference in depreciation	Generally, WDV method of dep. is adopted under IT Act which leads to higher dep. in earlier years of useful life of asset in comparison to later years.	Responding timing difference	Reversal of DTL	28 lakhs x 40% = ₹ 11.20 lakhs
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Responding timing difference	Reversal of DTA	14 lakhs x 40% = 5.6 lakhs
Share issue expenses	Due to disallowance of full expenditure under IT Act, tax payable in the earlier years was higher.	Responding timing difference	Reversal of DTA	7 lakhs x 40% = ₹ 2.8 lakhs
Repairs to plant and machinery	Due to allowance of full expenditure under IT Act, tax payable of the current year will be less.	Originating timing difference	Increase in DTL	70 lakhs x 40% =28 lakhs

Question 6 *(RTP May 2022)* *Pg no._____*

The following transactions were reported by PQR Ltd. during the year 2020-2021:

(i)	Tax Rate	30%
		(₹ In Lakhs)
(ii)	Items disallowed in 2019-20 & allowed for tax purposes in 2020-21	20.00
(iii)	Interest to Financial Institutions accounted in the books on accrual basis, but actual payment was made before the due date of filing return and allowed for tax purpose also.	20.00
(iv)	Donations to Private Trust made in 2020-2021 (not allowed under Income Tax Laws)	10.00

You are required to show impact of the above items in terms of Deferred Tax Assets/Deferred Tax Liability for the year ended 31.03.2021.

Solution

Impact of various items in terms of deferred tax liability/deferred tax asset on 31.3.21

Transactions	Analysis	Nature of difference	Effect	Amount (₹)
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Timing difference	Reversal of DTA	20 lakhs x 30% = ₹ 6 lakhs
Interest to financial institutions	It is allowed as deduction under IT Act, if the payment is made before the due date of filing the return of income	No Timing difference	Not Applicable	Not Applicable
Donation to private trusts	Not an allowable expenditure under IT Act.	Permanent difference	Not Applicable	Not Applicable

Question 7 *(ICAI Study Material)* *Pg no._____*

Saras Ltd. closes its books as on 31st March 2022. They have accrued ₹ 5,00,000 towards GST Liability for the month of March 2022 by debiting their Profit and loss statement which is expected to be paid off by 21st April 2022 . As per the provisions of Section 43B of the Income Tax Act, 1961 – Any expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.) accrued in the statement of profit and loss on mercantile basis will be allowed for tax purposes in subsequent years on payment basis only. Assuming a Tax rate of 30% determine the Deferred Tax Asset/Liability as at 31st March 2022.

Solution

Calculation of difference between taxable income and accounting income

Particulars	Amount
GST Liability debited in books	5,00,000
Less: GST Liability allowed under Income Tax Act (Section 43B)	Nil
Timing difference	5,00,000

Tax expense is less than the current tax due to timing difference.
Therefore, deferred tax Asset = 30% x 5,00,000 = 1,50,000

Question 8 *(Inter Nov 2022) (5 Marks)* *Pg no._____*

The following information is furnished in respect of Mohit Limited for the year ending 31st March,2022.

a) Depreciation as per accounting records ₹ 56,000
Depreciation for income tax records ₹ 38,000.
The above depreciation does not include depreciation on new addition.

b) A new machinery purchased on 1st April, 2021 costing ₹ 24,000 on which 100% depreciation in allowed in the 1st Year for income tax purpose, whereas straight line method of depreciation is considered appropriate for accounting purpose with a life estimation of 4 years.

c) The company has made a profit of ₹ 1,28,000 before depreciation and taxes.

d) Donation to private trust during the year is ₹ 15,000 (not allowed under Income tax laws.)

e) Corporate tax is 40%.

Prepare relevant extract of statement of Profit & Loss for the year ending 31 st March, 2022.
Also show the effect of the above items on Deferred Tax Liability/Assets as per AS 22.

Solution

Statement of profit and Loss for the year ended 31st March, 2022 (An Extract)

	₹
Profit before taxes and depreciation	1,28,000
Less: Depreciation (56,000+ 6,000)	(62,000)
Profit before tax	66,000
Less: Current tax (W.N)	(32,400)
Deferred Tax	Nil
Profit after tax	33,600

Working Note:

Computation of taxable income

	₹
Profit before taxes and depreciation	1,28,000
Less: Depreciation (38,000+ 24,000)	(62,000)
	66,000
Add: Donation*	15,000
	81,000
Current tax (40%)	32,400

Note: The profit of ₹ 1,28,000 given in question is before depreciation and taxes. It has been considered that this amount is after making adjustment of donation amounting ₹ 15,000.

Impact of various items in terms of deferred tax liability/deferred tax asset

	Transactions	Nature of difference	Effect	Amount
1.	Difference in depreciation (old machinery)	Timing difference	Reversal of DTL	₹ 18,000 (56,000 – 38,000) *40% = (+) ₹ 7,200
2.	Depreciation on new machinery	Timing difference	Creation of DTL	₹ 18,000 (24,000 – 6,000) *40%= (-) ₹ 7,200
3.	Donation to private trusts	Permanent difference	Not applicable	--
	Net Effect of Deferred Tax			Nil

Question 9

*Pg no.*_____

A company, ABC Ltd., prepares its accounts annually on 31st March. The company has incurred a loss of ₹ 1,00,000 in the year 2018 and made profits of ₹ 50,000 and 60,000 in year 2019 and year 2020 respectively. Under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 2018, 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. Also there is no difference between taxable income and accounting income except that set-off of loss is allowed in years 2019 and 2020 for tax purposes. Current tax in the year 2020 is ₹ 4,000. Show the effect of above transactions by preparing the Statement of Profit and Loss

Solution

Statement of Profit & Loss

	2018	2019	2020
Profit / (Loss)	(1,00,000)	50,000	60,000
Less: Current Tax	-	-	(4,000) [10,000*40%]

Deferred Tax: Tax effect of timing differences originating during the year (1,00,000 x 40%) Tax effect of timing differences reversed/ adjusted during the year (50,000 x 40%)	40,000	(20,000)	(20,000)
Profit / (Loss) after tax	**(60,000)**	**30,000**	**36,000**

Question 10 – *(ICAI Study Material)* *Pg no._____*

Y Ltd. is a full tax free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference is ₹ 200 lakhs and ₹ 400 lakhs respectively which will result in a tax liability in year 1 and 2. From the third year it is expected that the timing difference would reverse each year by ₹ 10 lakhs. Assuming tax rate of 40%, find out the deferred tax liability at the end of the second year and any charge to the Profit & Loss account.

Solution

As per AS 22, 'Accounting for Taxes on Income', deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income-tax Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence. For this purpose, timing differences which originate first should be considered to reverse first.

Out of ₹ 200 lakhs timing difference due to depreciation, difference amounting ₹ 80 lakhs (₹ 10 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognised. However, for ₹ 120 lakhs (₹ 200 lakhs – ₹ 80 lakhs), deferred tax liability will be recognised for ₹ 48 lakhs (40% of ₹ 120 lakhs) in first year.

In the 2nd year, entire amount of timing difference of ₹ 400 lakhs will reverse only after tax holiday period & hence, will be recognised in full. Deferred tax liability amounting ₹ 160 lakhs (40% of ₹ 400 lakhs) will be created by charging it to profit & loss account and total balance of deferred tax liability account at end of 2nd year will be ₹ 208 lakhs (48 lakhs + 160 lakhs).

Question 11 *(Inter Nov 2019) (5 Marks)* *Pg no._____*

Sheetal Ltd. has provided the following information for the year ended 31-03-2020:

Particulars	₹
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	7.50%

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.

Solution

Tax as per accounting profit 9,00,000 x 30% = ₹ 2,70,000
Tax as per Income-tax Profit 95,000 x 30% = ₹ 28,500
Tax as per MAT 5,25,000 x 7.50% = ₹ 39,375

Tax expense= Current Tax + Deferred Tax
₹ 2,70,000 = ₹ 28,500+ Deferred tax
Therefore, Deferred Tax liability as on 31-03-2020 = ₹ 2,70,000 – ₹ 28,500 = ₹ 2,41,500
Amount of tax to be debited in Profit and Loss account for the year 31-03-2020
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

Question 12 *(Inter Nov 2020) (5 Marks) / (RTP Nov 2023)* *Pg no._____*

From the following details of Aditya Limited for accounting year ended on 31st March, 2020

Particulars	₹
Accounting Profit	15,00,000
Book Profit as per MAT	7,50,000
Profit as per Income Tax Act	2,50,000
Tax Rate	20%
MAT Rate	7.50%

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.

Solution

Tax as per accounting profit 15,00,000 x 20% = ₹ 3,00,000
Tax as per Income-tax Profit 2,50,000 x 20% = ₹ 50,000
Tax as per MAT 7,50,000 x 7.50% = ₹ 56,250
Tax expense= Current Tax + Deferred Tax
₹ 3,00,000 = ₹ 50,000+ Deferred tax
Therefore, Deferred Tax liability as on 31-03-2020 = ₹ 3,00,000 – ₹ 50,000 = ₹ 2,50,000
Amount of tax to be debited in Profit and Loss account for the year 31-03-2020
Current Tax + Deferred Tax liability + Excess of MAT over current tax
= ₹ 50,000 + ₹ 2,50,000 + ₹ 6,250 (56,250 – 50,000) = ₹ 3,06,250

Question 13 *(RTP May 2021)* *Pg no._____*

What are the disclosure requirements for deferred tax assets and deferred tax liabilities in the balance sheet as per AS 22?

Solution

The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period.
Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities. The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

Question 14 *(RTP Nov 2021)* *Pg no._____*

Can an enterprise offset deferred tax assets and deferred tax liabilities? If yes, prescribe the conditions required for such offset as per provisions of AS 22.

Solution

Yes. It can offset deferred tax assets and deferred tax liabilities.

As per AS 22, an enterprise should offset deferred tax assets and deferred tax liabilities if:

(i) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

(ii) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

Question 15 *(RTP May 2019)* *Pg no._____*

Is it permissible not to recognize deferred tax liability on the ground that Company expects that there will be losses both for accounting & tax purposes in near future? You are required to give advice to company.

Solution

The Company should provide for deferred tax liability on the timing differences irrespective for the fact that these timing differences will reverse in the period in which the Company expects to be in loss both from the accounting as well as tax point of view. It may, however, be added that the deferred tax liability recognized at the balance sheet date will give rise to future taxable income at the time of reversal thereof.

Question 16 *(Inter Sep 2024) (5 Marks)* *Pg no._____*

Delta Ltd. is working on different projects those are likely to be completed within 3 years period. It recognizes revenue from these contracts on Percentage of Completion Method for Financial Statements for the years ending 2021, 2022 and 2023 for ₹ 34 Lakhs, ₹ 50 Lakhs and ₹ 65 Lakhs respectively.

However, for Income Tax purpose, it has adopted the Completed Contract Method under which it has recognized revenue of ₹ 30 Lakhs, ₹ 52 Lakhs and ₹ 67 Lakhs for the years ending 2021, 2022 and 2023 respectively. Income Tax rate is 30%.

Compute the amount of Deferred Tax Asset / Liability and Total Tax Expenses for the years ending 31st March 2021, 2022 and 2023.

Solution

Calculation of Deferred Tax Asset/Liability in Delta Limited

Year	Accounting Income	Taxable Income	Timing Difference	Timing Difference (balance)	Deferred Tax	Deferred Tax Liability (balance)
2021	34,00,000	30,00,000	4,00,000	4,00,000	1,20,000	1,20,000
2022	50,00,000	52,00,000	(2,00,000)	2,00,000	(60,000)	60,000
2023	65,00,000	67,00,000	(2,00,000)	NIL	(60,000)	NIL
	1,49,00,000	**1,49,00,000**				

Calculation of total tax

Year	Deferred Tax	Current tax expense	Total tax
2021	1,20,000	9,00,000 (30,00,000 x 30%)	10,20,000
2022	(60,000)	15,60,000 (52,00,000 x 30%)	15,00,000
2023	(60,000)	20,10,000 (67,00,000 x 30%)	19,50,000

Note: It is assumed that the revenue and the taxable profit is same.

ACCOUNTING FOR INVESTMENT IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

AS 23

Coverage	AS 23 describes the principles procedures for recognizing investments in associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable.
Objective	The objective of this Standard is to lay down principles and procedures for recognizing the investments in associates and its effect on the financial operations of the group in the consolidated financial statements. Reference to AS 23 is compulsory for the companies following AS 21 and preparing consolidated financial statement for their group.
Meaning of Associate	An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. ***Significant influence is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies.*** Any enterprise having 20% or more of the voting power or any interest directly or indirectly in any other enterprise will be assumed to have significantly influence the other enterprise unless proved otherwise. Significant influence may be gained by share ownership, statute or agreement.
Examples	**Example 1** A Ltd. has 70% holding in C Ltd. and B Ltd. also has 28% holding in the same company. So, A Ltd. with the majority holding i.e. more than 50% is the parent company i.e. a holding company. Since B Ltd. holds more than 20% but not more than 50% in C Ltd., C Ltd. will be an associate of B Ltd. **Example 2** A Ltd. is holding 90% share in B Ltd. and 10% shares in C Ltd., and B Ltd. is holding 11%shares in C Ltd. In this case, A Ltd. is parent of B Ltd. As far as the relationship between A Ltd. and C Ltd. is concerned; A Ltd. has a total of direct and indirect holding of (10 + 11) 21% in C Ltd., Thus, C Ltd. is an associate of A Ltd. It may however be noted that for consolidated financial statement purposes, the holding will be 19.9% (10% + 90% of 11%).
Accounting as per Equity Method	The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition.

	The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee. Goodwill/capital reserve arising on the acquisition of an associate by an investor should be included in the carrying amount of investment in the associate but should be disclosed separately. From the definition, following broad conclusions can be drawn: a. Investment is initially recorded at cost. b. Any surplus or deficit in cost and net asset to be recorded as goodwill or capital reserve. c. Distributions received from an investee reduce the carrying amount of the investment. d. Any subsequent change in share in net asset is adjusted in cost of investment and goodwill/capital reserve. e. Consolidated Profit & Loss shows the investor's share in the results of operations of the investee.
Circumstances under which Equity Method is Followed	Equity method of accounting is to be followed by all the enterprises having significant influence on their associates **except** in the following cases: a. Control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future. b. Or it operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor. In both the above cases, investment of investor in the share of the investee is treated as investment according to AS 13. An investor should **discontinue the use of the equity method** from the date that: a. It ceases to have significant influence in an associate but retains, either in whole or in part, its investment. b. The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with AS 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.
Applicability of Equity Method	Many of the rules followed under equity method for an associate is similar to consolidated financial statement rules as in case of subsidiary i.e. AS 21. Investment in an associate should be recorded as per the equity method from the date when such relation comes in effect. Investment in the associate is recorded at cost and any difference in the cost and investor's share in equity on the date of acquisition is shown as goodwill or capital reserve

Why Equity method adopted?	Investments in associates cannot be treated as a normal investment under AS 13. The intent of investing to such an extent (i.e.; 20% or more but less than 50% of equity) in an associate is an expression of the fact that the investor is not merely interested in the dividend distribution, but also is interested in the participation of decision-making process in the associate. As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate's performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include its share of results of such an associate and so provides an analysis of earnings and investment from which more useful ratios can be calculated. As a result, application of the equity method in consolidated financial statements provides more informative reporting of the net assets and net income of the investor.
Step Acquisition in case of an associate	An enterprise having share of profits of more than 50% in other company, they are said to be in Parent-Subsidiary relationship. However, if the share in profits is more than 20% but upto 50% then this relationship is termed as associate relationship. This stake of 20% can be acquired either in one go or in more than one transaction. This share of stake can be increased further say from 25% to 30%. Adjustment should be made with each transaction.
Different Reporting Dates	As far as possible the reporting date of the financial statements should be same for consolidated financial statement. If practically it is not possible to draw up the financial statements of one or more enterprise to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the investor, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the consolidated financial statements. In any case, the difference between reporting dates of the concern and consolidated financial statement should not be more than 6 months.
Uniform Accounting Policies	Accounting policies followed in the preparation of the financial statements of the investor, investee and consolidated financial statement should be uniform for like transactions and other events in similar circumstances. If accounting policies followed by different enterprises in the group are not uniform, then adjustments should be made in the items of the individual financial statements to bring it in line with the accounting policy of the consolidated statement.
Contingencies	As per AS 4, the investor discloses in the consolidated financial statements: a. Its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and b. Those contingencies that arise because the investor is severally liable for the liabilities of the associate.

Carrying Value of Investment	The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.
Disclosures	❖ In addition to the disclosures required above, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements. ❖ Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed. ❖ The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements. ❖ In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies ❖ If an associate is not accounted for using the equity method the reasons for not doing the same. ❖ Goodwill/capital reserve arising on the acquisition of an associate by an investor should be disclosed separately though it is included in the carrying amount of the investment.
Treatment of Proposed Dividend	In case an associate has made a provision for proposed dividend (i.e. dividend declared after the reporting period but it pertains to that reporting year) in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.
Consideration of Potential Equity Share	The potential equity shares of the investee held by the investor should not be taken into account for determining the voting power of the investor.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)*

A Ltd. acquire 45% of B Ltd. shares on April 01, 2021, the price paid was ₹ 15,00,000. Following are the extracts of balance sheet of B Ltd. as of 1 April 2021:

Paid up Equity Share Capital	₹ 10,00,000
Securities Premium	₹ 1,00,000
Reserve & Surplus	₹ 5,00,000

B Ltd. has reported net profits of ₹ 3,00,000 and paid dividends of ₹ 1,00,000 for the year ended 31 March 2022. Calculate the amount at which the investment in B Ltd. should be shown in the consolidated balance sheet of A Ltd. as on March 31, 2022.

Question 2 *(ICAI Study Material)*

A Ltd. acquired 40% share in B Ltd. on April 01, 2021 for ₹ 10 lacs. On that date B Ltd. had 1,00,000 equity shares of ₹ 10 each fully paid and accumulated profits of ₹ 2,00,000. During the year 2021-2022, B Ltd. suffered a loss of ₹ 10,00,000; during 2022-2023 loss of ₹ 12,50,000 and during 2023-2024 again a loss of ₹ 5,00,000. Show the extract of consolidated balance sheet of A Ltd. on all the four dates recording the above events.

Solution

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	₹
Equity Shares	10,00,000
Reserves & Surplus	2,00,000
Net Assets	12,00,000
40% share of Net Assets	4,80,000
Less: Cost of Investment	(10,00,000)
Goodwill	5,20,000

Consolidated Balance Sheet (Extract) as on April 01, 2021: ASSETS

Investment in Associate as per AS 23	₹	₹
Share of Net Assets on April 1	4,80,000	
Add: Goodwill	5,20,000	10,00,000

Calculation of Carrying Amount of Investment as at 31 March 2022:

Investment in Associate as per AS 23	₹
Share of Net Assets on 1 April, 2021	4,80,000
Add: Goodwill	5,20,000
Cost of Investment	10,00,000
Less: Loss for the year (10,00,000 x 40%)	(4,00,000)
Carrying Amount of Investment	6,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2022: ASSETS

Investment in Associate as per AS 23	₹	₹
Share of Net Assets on 1 April, 2021	4,80,000	
Less: Share of Loss as above	(4,00,000)	
	80,000	
Add: Goodwill	5,20,000	6,00,000

Calculation of Carrying Amount of Investment as at 31 March 2023:

Investment in Associate as per AS 23	₹
Carrying Amount of Investment as on 31 March 2022	6,00,000
Less: Loss for the year (12,50,000 x 40%)	(5,00,000)
Carrying Amount of Investment	1,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2023: ASSETS

Investment in Associate as per AS 23	₹	₹
Share of Net Assets on 1 April, 2021	4,80,000	
Less: Share of Loss as above (₹4,00,000 +₹ 5,00,000)	(9,00,000)	
	(4,20,000)	
Add: Goodwill	5,20,000	1,00,000

Calculation of Carrying Amount of Investment as at 31 March 2024:

Investment in Associate as per AS 23	₹
Carrying Amount of Investment	1,00,000
Less: Loss for the year (5,00,000 x 40% = 2,00,000, restricted to Carrying amount of Investment in B Ltd.) - refer note below	(1,00,000)
Carrying Amount of Investment	-

Consolidated Balance Sheet (Extract) as on March 31, 2024: ASSETS

Investment in Associate as per AS 23	₹
Investment in B Ltd.	-

If, under the equity method, an investor's share of losses of an associate equal or exceeds the carrying amount of the investment, the investor ordinarily discontinues recognizing its share of further losses and the investment is reported at nil value.
If the associate subsequently reports profits, the investor resumes including its share of those profits only after its share of the profits equals the share of net losses that have not been recognised.

Question 3 *(ICAI Study Material)*

Bright Ltd. acquired 30% of East India Ltd. shares for ₹ 2,00,000 on 01-06-2021. By such an acquisition Bright can exercise significant influence over East India Ltd.
During the financial year ending on 31-03-2021 East India earned profits ₹ 80,000 and declared a dividend of ₹ 50,000 on 12-08-2021. East India reported earnings of ₹ 3,00,000 for the financial year ending on 31-03-2022 (assume profits to accrue evenly) and declared dividend of ₹ 60,000 on 12-06-2022. Calculate the carrying amount of investment in:

i. Separate financial statements of Bright Ltd. as on 31-03-2022.
ii. Consolidated financial statements of Bright Ltd.; as on 31-03-2022.
iii. What will be the carrying amount as on 30-06-2022 in consolidated financial statements?

Question 4 *(ICAI Study Material)*

A Ltd. acquired 25% of shares in B Ltd. as on 31.3.2021 for ₹ 3 lakhs. TheBalance Sheet of B Ltd. as on 31.3.2021 is given below:

	₹
Share Capital	5,00,000
Reserves and Surplus	5,00,000
	10,00,000

Property, Plant & Equipment	5,00,000
Investments	2,00,000
Current Assets	3,00,000
	10,00,000

During the year ended 31.3.2022 the following are the additional informationavailable:

a. On 30.04.2021, A Ltd. received dividend from B Ltd., for the year ended 31.3.2021 at 40% from Reserves. The above balance sheet is before adjustment of dividend.
b. B Ltd., made a profit after tax of ₹ 7 lakhs for the year ended 31.3.2022.
c. B Ltd., declared a dividend @ 50% for the year ended 31.3.2022 on 30.4.2022.

A Ltd. is preparing Consolidated Financial Statements in accordance with AS21 for its various subsidiaries. Calculate:

a. Goodwill if any on acquisition of B Ltd.'s shares.
b. How A Ltd., will reflect the value of investment in B Ltd., in Consolidated Financial Statements?
c. How the dividend received for 31.03.2022 on 30.04.2022 from B Ltd. will be shown in ConsolidatedFinancial Statements?

Question 5 *(RTP Sep 2024)*

Hill Ltd. has a share capital of 50,000 shares @ ₹ 100 per share. Sun Ltd. acquired 15% shares in Hill Ltd. on 1.4.2024. It also acquired all the 5,000, 12% convertible debentures of ₹ 100 each of Hill Ltd. These debentures will be converted at par into equity shares of Hill Ltd. after 3 years. State whether, as per AS 23, Hill Ltd. is an Associate of Sun Ltd. or not with reasons?

Solution

As per para 3 of AS 23 'Accounting for Investments in Associates in Consolidated Financial Statements', an associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Standard further explains in para 4 that as regards share ownership, if an investor holds, directly or indirectly through subsidiary (ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiary (ies), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated.

Further as per an explanation to para 4 of the standard, for the purpose of classification of associate, the potential equity shares of the investee held by the investor will not be taken into account for determining the voting power of the investor. In other words, the voting power should be determined on the basis of the current outstanding securities with voting rights.

As per the information given in the question, Sun Ltd. presently holds indirectly 22.7% shares (with and without voting rights) (Refer W.N.) in Hill Ltd. However, the current outstanding securities with voting rights in Hill Ltd. is only 15% and the remaining holding is on account of potential equity shares. Since potential equity shares do not have voting rights they will not be taken into consideration while determining the significant influence of Sun Ltd. on Hill Ltd. Hence, Hill Ltd. is not an associate of Sun Ltd.

Working Note: Calculation of percentage of holding of shares after conversion

	₹
Current holding is 15% i.e. 7,500 shares of ₹ 100 each	7,50,000
Potential equity shares i.e. 5,000 shares of ₹ 100 each	5,00,000
	12,50,000

Total share capital of Hill Ltd. after conversion of debentures into equity shares will be = ₹ 50,00,000 + ₹ 5,00,000 = ₹ 55,00,000
Percentage of holding = ₹ (12,50,000/55,00,000) x 100 = 22.7% approx.

Question 6 *(RTP Jan 2025)*

A Ltd. invested ₹ 1,00,000 to acquire 10% stake (Investment I) in B Ltd. and later invested ₹ 3,00,000 to acquire additional 20% (Investment II). The net asset value of the B Ltd. at the respective investment dates was ₹ 7,50,000 and ₹ 12,50,000 respectively.
Determine whether B Ltd. is an associate of A Ltd. Also, calculate goodwill arising on the acquisition of the associate.

Solution

As per para 3 of AS 23 an associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiary(ies), 20% or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. In this case, A Ltd. has invested 30 % in B Ltd. so B Ltd. is to be considered as an associate of A Ltd.
The goodwill arising on the acquisition of the associate will be computed as follows:

		₹
Investment I		1,00,000
Share of net assets	(10% of ₹ 7,50,000)	(75,000)
Goodwill (A)		25,000
Investment II		3,00,000
Share of net assets	(20% of ₹ 12,50,000)	(2,50,000)
Goodwill (B)		50,000
Total goodwill (A + B)		**75,000**

Question 7 *(Inter Sep 2024) (14 Marks)*

On 1st February, 2024, Best Ltd. acquired 80% Equity shares of Cool Ltd. for ₹ 14,80,000.
On 31st March, 2024, Best Ltd. also acquired 25% Equity shares of Good Ltd. for ₹ 3,80,000.
The following are the balances extracted from the books of Best Ltd., Cool Ltd., and Good Ltd. as on 31st March, 2024 :

Particulars	Best Ltd. Amount in ₹	Cool Ltd. Amount in ₹	Good Ltd. Amount in ₹
Equity Shares of ₹ 100 each fully paid	30,00,000	20,00,000	10,00,000
Securities Premium	-	2,20,000	-
9% Debentures	6,30,000	-	2,40,000
General Reserve	2,69,000	84,000	1,20,000
Profit and Loss Account (Credit Balance)	3,26,000	2,70,000	50,000
Investments	17,50,000	6,10,000	-
Property, Plant, and Equipment	18,90,000	18,14,000	12,10,000

Current Assets	9,65,000	5,60,000	2,25,000
Trade Payable (Including Bills Payable)	3,80,000	4,10,000	25,000
Sales and other income	56,00,000	38,00,000	27,00,000
Raw material consumed	36,50,000	31,20,000	22,30,000
Wages and Salaries	5,07,000	4,01,000	2,69,000
Production expenses	1,35,000	1,06,000	98,000

Additional information:

- Profit and Loss account of Cool Ltd. showed a credit balance of ₹ 30,000 on 1st April, 2023.
- The General Reserve balance is brought forward from the previous year.
- On 31st March, 2024, all the bills payable in Cool Ltd.'s balance sheet were acceptances in favour of Best Ltd. However, on the date, Best Ltd. held only ₹ 3,00,000 of these acceptances in hand, the rest having been endorsed in favour of its creditor.
- Best Ltd. purchased goods costing ₹ 5,00,000 from Cool Ltd. on 1st June, 2023 at a price of ₹ 6,50,000. The entire goods remain unsold with Best Ltd. at the end of the financial year.
- Best Ltd. is preparing Consolidated Financial Statements for the year ending 31.03.2024.

You are required to calculate:

(1) Trade Payable (Consolidated)
(2) Current Assets (Consolidated)
(3) Minority Interest
(4) Goodwill/Capital Reserve on the acquisition of Cool Ltd.'s shares
(5) Goodwill/Capital Reserve on the acquisition of Good Ltd.'s shares
(6) Profit and Loss Account (Consolidated)
(7) General Reserve (Consolidated)
(8) Revenue from Operations (Consolidated)
(9) Cost of material purchased/consumed (Consolidated)

Solution

1. Trade payable (Consolidated)

Best limited	3,80,000
Add: Cool Ltd	4,10,000
Less: Elimination	(3,00,000)
Total	**4,90,000**

2. Current assets (Consolidated)

Best limited		9,65,000
Add: Cool Ltd		5,60,000
Less: Elimination of inter company owing	(3,00,000)	
Less: Unrealized stock profit	(1,50,000)	(4,50,000)
Total		**10,75,000**

3. Minority interest Cool Ltd

Share Capital (20,00,000 x 20%)		4,00,000
Add: Securities premium (2,20,000 x 20%)		44,000
Add: General Reserve (84,000 x 20%)		16,800
Add: Profit and loss balance	2,70,000	
Less: Adjustment of unrealised profit stock	(1,50,000)	
Balance	1,20,000	
20% of above balance		24,000
Total		**4,84,800**

4. Goodwill/Capital Reserve on Acquisition of Cool Ltd.:

Purchase Consideration		14,80,000
Less: Share Capital (20,00,000 x 80%)		16,00,000
Less: Securities premium (2,20,000 x 80%)		1,76,000
Less: General Reserve (84,000 x 80%)		67,200
Less: Profit and loss balance opening (30,000 x 80%)		24,000
Less: Pre acquisition profits (2,70,000-30,000) x 10/12 x 80%	1,60,000	
Less: Unrealised profit stock (1,50,000 x 80%)	(1,20,000)	40,000
Capital Reserves		**4,27,200**

5. Goodwill/Capital Reserve on Acquisition of Good Ltd.

Purchase Consideration	3,80,000
Less: Share Capital (10,00,000 x 25%)	2,50,000
Less: General Reserve (1,20,000 x 25%)	30,000
Less: Profit and loss balance (50,000 x 25%)	12,500
Goodwill	**87,500**

6. Profit and Loss Account (Consolidated)

Best limited	3,26,000
Add: Post acquisition profit of Cool Ltd	
{(2,70,000-30,000) x 2/12}80%	32,000
Total	**3,58,000**

7. General Reserve (Consolidated)

Best limited	2,69,000

8. Revenue (Consolidated) as per para no 15 and 22 of AS 21

Revenue of Best Ltd	56,00,000
Add: Revenue of Cool Ltd. (38,00,000 × 2/ 12)	6,33,333
	62,33,333

9. Cost of materials purchased/consumed (Consolidated) as per para no 15 and 22 of AS 21

Raw material of Best Ltd	36,50,000
Add: Raw material of Cool Ltd (31,20,000x 2/12)	5,20,000
	41,70,000

Para no 15 of AS 21

If an enterprise makes two or more investments in another enterprise at different dates and eventually obtains control of the other enterprise, the consolidated financial statements are presented only from the date on which holding-subsidiary relationship comes in existence.

Para no 22 of AS 21

The results of operations of a subsidiary are included in the consolidated financial statements as from the date on which parent-subsidiary relationship came in existence. The results of operations of a subsidiary with which parent- subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of the relationship.

DISCONTINUING OPERATIONS

AS 24

Objective	AS 24 is applicable to all discontinuing operations. The objective of AS 24 is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.
Discontinuing Operation	A discontinuing operation is a component of an enterprise: **(PARA 3)** a) That the enterprise, pursuant to a single plan, is: ➢ ***Disposing of substantially in its entirety***, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or ➢ ***Disposing of piecemeal***, such as by selling off the component's assets and settling its liabilities individually or ➢ Terminating through ***abandonment*** and b) That represents a separate major line of business or geographical area of operations. c) That can be distinguished operationally and for financial reporting purposes. A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met: a. The operating assets & liabilities of the component can be directly attributed to it. b. Its revenue can be directly attributed to it. c. At least majority of its operating expenses can be directly attributed to it. Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations. The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 does not, in itself, bring into question the enterprise's ability to continue as a going concern. ***Examples of activities*** that do not necessarily satisfy criterion(a)of definition, but that might do so in combination with other circumstances, include: ❖ Gradual or evolutionary phasing out of a product line or class of service. ❖ Discontinuing, even if relatively abruptly, several products within an ongoing line of business. ❖ Shifting of some production or marketing activities for a particular line of business from one location to another and ❖ Closing of a facility to achieve productivity improvements or other cost savings. An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

Initial Disclosure event	Occurrence of one of the following, ***whichever occurs earlier:*** a) The enterprise has entered into a binding sale agreement for substantially all of assets attributable to the discontinuing operation or b) The enterprise's board of directors or similar governing body has both (i) approved a detailed, formal plan for the discontinuance and (ii) made an announcement of the plan. A detailed, formal plan for the discontinuance normally includes: ➢ identification of the major assets to be disposed of; ➢ the expected method of disposal; ➢ the period expected to be required for completion of the disposal; ➢ the principal locations affected; ➢ the location, function, and approximate number of employees who will be compensated for terminating their services; and ➢ the estimated proceeds or salvage to be realised by disposal. An enterprise's board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, trade payables, trade unions, etc. in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.
Recognition and Measurement	For recognising and measuring the effect of discontinuing operations, this AS does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.
Presentation & Disclosure (Initial Disclosure)	An enterprise should include following information relating to discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs: ❖ A description of the discontinuing operation(s) ❖ The business or geographical segment(s) in which it is reported as per AS 17 ❖ The date and nature of the initial disclosure event. ❖ The date or period in which the discontinuance is expected to be completed if known or determinable ❖ The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled ❖ The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period ❖ The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto ❖ The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period
Presentation of the above disclosures	All the disclosures above should be presented in the notes to the financial statements **except** for amounts pertaining to pre-tax profit/loss of the discontinuing operation and the income tax expense thereon (second last above) which should be shown on the face of the statement of profit and loss.

Other disclosures	When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur: a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.
Updating the disclosures	In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes. The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received. Any disclosures required by AS 24 should be presented separately for each discontinuing operation.
Restatement of Prior Periods	Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.
Disclosure in interim financial reports *(RTP Nov 2022)*	Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, 'Interim Financial Reporting', including: a. Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and b. Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

Example 1:
Co XY runs a famous chain of restaurants. It decides to sell its stake in one of the restaurant. This restaurant contributes around 5% of total revenue to the entire business. XY does not intend to sell any other restaurant as part of its strategy.

In the above case, the sale of one restaurant out of the chain does not constitute disposal of business under a single plan, or a portion that represents a major line of business or geographical area of operations. Thus, it cannot be regarded as a discontinuing operation.

Example 2:
Group MN operates in various industries including Hotels, Airlines and Software through its subsidiaries. It has decided to sell its Airline business to be able to concentrate on other verticals. As a result, it has started to sell its aircrafts and paying off the associated liabilities. During the year, it has sold off 5 aircrafts out of the fleet of 50 aircrafts so far as part of the sale. The Airline business constitutes 25% of total group revenue.

In the above case, Airline business may be considered as discontinuing operation. This is due to the fact that the assets are sold off as part of a single plan, and that the business represents a separate major line of business, and can be distinguished both operationally and for financial reporting purposes.

Example 3:
GH, a large car manufacturing company, decides to discontinue its manufacturing operations relating to the diesel cars production. It plans to restructure the business by revamping its existing operations, and starting new manufacturing process for manufacture and sale of electric vehicles.

In the above example, it needs to be evaluated whether the restructuring is a result of continuing operations, or termination of existing operations, and accordingly it can be concluded whether it is a case of discontinuing operations or not.

Example 4:
Entity RT operates in a single state and is trading in 3 products – X, Y and Z. Details with respect to the performance of each of the products are as under:

Particulars	**X**	**Y**	**Z**	**Total**
Sales	1,00,000	14,00,000	20,00,000	35,00,000
Cost of Goods Sold	(80,000)	(10,80,000)	(14,40,000)	(26,00,000)
Gross Margin	20,000	3,20,000	5,60,000	9,00,000
Operational Expenses	(15,000)	(1,70,000)	(3,60,000)	(5,45,000)
Profit before tax	**5,000**	**1,50,000**	**2,00,000**	**3,55,000**

RT has decided to sell the business relating to Product Y to another entity. Since Product Y constitutes a major product, it may be considered as a discontinuing operations.

ASSIGNMENT QUESTIONS

Question 1 *(RTP May 2018) / (RTP May 2023)/ (ICAI Study Material)*

A consumer goods producer has changed the product line as follows:

	Dish Washing Bar (per month)	Clothes Washing Bar (per month)
January, 2021 – September, 2021	2,00,000	2,00,000
October, 2021 – December, 2021	1,00,000	3,00,000
January, 2022- March, 2022	0	4,00,000

The company has enforced a gradual enforcement of change in product-line on the basis of an overall plan. The Board of Directors of the company has passed a resolution in March, 2021 to this effect. The company follows calendar year as its accounting year. You are required to advise whether it should be treated as a discontinuing operation or not as per AS 24?

Solution

As per AS 24, a **discontinuing operation** is a component of an enterprise:

a. That the enterprise, pursuant to a single plan, is:
   (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
   (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or
   (iii) Terminating through abandonment and

b. That represents a separate major line of business or geographical area of operations.

c. That can be distinguished operationally and for financial reporting purposes.

Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

1) Gradual or evolutionary phasing out of a product line or class of service.
2) Discontinuing, even if relatively abruptly, several products within ongoing line of business.
3) Shifting of some production or marketing activities for a particular line of business from one location to another and
4) Closing of a facility to achieve productivity improvements or other cost savings.

In the given case, the company has enforced a gradual enforcement of change in product line and does not represent a separate major line of business and hence is not a discontinued operation. If it were a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(i) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or
(ii) the enterprises board of directors or similar governing body has both approved a detailed, formal plan for discontinuance and made an announcement of the plan.

Question 2 *(Inter July 2021) (5 Marks)/(RTP May 2021)/(May 2024)/(Sep 2024) (ICAI Study Mat.)*

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Rohini Limited is in the business of manufacture of passenger cars and commercial vehicles. The Company is working on a strategic plan to close the production of passenger cars and to produce only commercial vehicles over the coming 5 years. However, no specific plans have been drawn up for sale of neither the division nor its assets. As part of its prospective plan it will reduce the production of passenger cars by 20% annually. It also plans to establish another new factory for the manufacture of commercial vehicles and transfer surplus employees in a phased manner. You are required to comment:

a) If mere gradual phasing out in itself can be considered as a 'discontinuing operation' within the meaning of AS-24.
b) If the Company passes a resolution to sell some of the assets in the passenger car division and also to transfer few other assets of the passenger car division to the new factory, does this trigger the application of AS-24?
c) 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?

Solution

a) As per AS 24, a **discontinuing operation** is a component of an enterprise:
a. That the enterprise, pursuant to a single plan, is:
(i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
(ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or
(iii) Terminating through abandonment and
b. That represents a separate major line of business or geographical area of operations.
c. That can be distinguished operationally and for financial reporting purposes.
Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:
1) Gradual or evolutionary phasing out of a product line or class of service.
2) Discontinuing, even if relatively abruptly, several products within ongoing line of business.
3) Shifting of some production or marketing activities for a particular line of business from one location to another and
4) Closing of a facility to achieve productivity improvements or other cost savings.

In this case, mere gradual phasing cannot be considered as Discontinuing Operation as per AS-24 as the companies' strategic plan has no final approval from the board through a resolution and there is no specific time bound activities like shifting of assets and employees. Moreover, the new segment i.e. commercial vehicle production line in a new factory has not started.

b) No, the resolution is silent about stoppage of the Car segment in definite time period. Though, sale of some assets and some transfer proposal were passed through a resolution to the new factory, but the closure road map and new segment starting roadmap are missing. Hence, AS 24 will not be applicable and it cannot be considered as Discontinuing operations.

c) Yes, phased and time bound program resolved in the board clearly indicates the closure of the passenger car segment in a definite time frame and will constitute a clear roadmap. Hence, this action will attract compliance of AS 24 and it will be considered as Discontinuing Operations as per AS-24.

Question 3 *(RTP Nov 2018) / (May 2020) / (May 2022) /(Jan 2025)/ (ICAI Study Material)*

Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.

Solution

Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operations. According to Paragraph 9 of AS 24, examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

a) Gradual or evolutionary phasing out of a product line or class of service;
b) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;
c) Shifting of some production or marketing activities for a particular line of business from one location to another; and
d) Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

Question 4 *(Inter Nov 18)/(Nov 23) (5 Marks)/(RTP May 20)/(Nov 20)/(May 22)/(Jan 25) (ICAI SM)*

What are the disclosure and presentation requirements of AS 24 for discontinuing operations?

Solution

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:

a) a description of the discontinuing operation(s);
b) the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;
c) the date and nature of the initial disclosure event;
d) the date or period in which the discontinuance is expected to be completed if known or determinable;
e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;
f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;
g) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto; and
h) the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

Question 5 *(RTP Nov 2021)*

What are discontinuing operations as per AS 24? Should an enterprise include prescribed information relating to a discontinuing operation in its financial statements?

Solution

As per AS 24, a discontinuing operation is a component of an enterprise:

a. That the enterprise, pursuant to a single plan, is:
   (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or
   (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or
   (iii) Terminating through abandonment and
b. That represents a separate major line of business or geographical area of operations.
c. That can be distinguished operationally and for financial reporting purposes.

An enterprise should include prescribed information relating to a discontinuing operation in its financial statements, as per requirements of AS 24, beginning with the financial statements for the period in which the initial disclosure event occurs.

INTERIM FINANCIAL REPORTING

AS 25

Scope	The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, lenders and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity. *AS 25 does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard.* A statute governing an enterprise, or a regulator may also require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.
Interim Period	Interim period is a financial reporting period shorter than a full financial year
Interim Financial Report	Interim financial report means a financial report *containing either a complete set of financial statements or a set of condensed financial statements for an interim period.* During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period.
Contents of an Interim Financial Report	A complete set of financial statements normally includes Balance sheet, Statement of Profit & Loss, Cash flow statement and Notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements. Interim financial report may contain a complete set of financial statements or condensed financial statements. If the entity opted for a complete set of financial statements, it will be like annual set of financial statements. The condensed financial statements would include limited information as required by this standard. The recognition and measurement principles set out in this Standard apply also to complete financial statements for an interim period, and such statements would include all disclosures required by this Standard as well as those required by other Accounting Standards.

Form and Content of Interim Financial Statements	❖ If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading. ❖ If an enterprise presents basic & diluted earnings per share in its annual financial statements in accordance with AS 20 then it has to present basic & diluted earnings per share as per AS 20 on the face of Statement of Profit & Loss complete or condenses for an interim period also.
Selected Explanatory Notes	An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report: (a) A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change (b) Explanatory comments about the seasonality of interim operations. (c) The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that is unusual because of their nature, size, or incidence as per AS 5. (d) The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period. (e) Issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares. (f) Dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares. (g) Segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements). (h) The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations and (i) Material changes in contingent liabilities since the last annual balance sheet date. The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

Periods for which INTERIM FINANCIAL STATEMENTS are required to be presented

Interim reports should include interim financial statements (whether condensed or complete) for the periods listed in the following table:

Statement	Current 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

Materiality	In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. "Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information". For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data.
Disclosure in Annual Financial Statements	AS 5, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Similarly, if an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.
Accounting Policies	Same Accounting Policies as annual financial statements. An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. However, the nature and amount of any significant changes in estimates be disclosed.

Changes in Accounting Policies	Preparers of interim reports in compliance with AS 25 are required to consider any changes in accounting policies that will be applied for the next annual financial statements, and to implement the changes for interim reporting purposes. If there has been any change in accounting policy since the most recent annual financial statements, the interim report is required to include a description of the nature and effect of the change.
Revenue Received Seasonally or Occasionally	Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year. ***For example:*** Dividend revenue, royalties, and government grants. Additionally, some enterprises consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur.
Cost Incurred Unevenly during the Financial Year	Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year. A cost that does not meet the definition of an asset at the end of an interim period is not deferred in the interim balance sheet. Deferral of costs as assets in an interim balance sheet in the hope that the criteria will be met before the year-end is prohibited.
Use of Estimates	The measurement procedures to be followed in an interim financial report should be designed to ensure that resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of enterprise is appropriately disclosed.
Restatement of Previously Reported Interim Periods	One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle requires that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.
Transitional Provision	On the first occasion that an interim financial report is presented in accordance with this Statement, the following need not be presented in respect of all the interim periods of the current financial year: (a) Comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and (b) Comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.
Applicability of AS 25 to Interim Financial Results	The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)*

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 provisions of AS 25 shouldbe 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 interimfinancial results.

Question 2 *(ICAI Study Material)*

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, 2021 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.

Question 3 *(ICAI Study Material)*

Accountants of Poornima Ltd. showed a net profit of ₹ 7,20,000 for the third quarter of 2021 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, 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.
Recognizing 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).

Question 4 *(ICAI Study Material)*

On 30th June, 2021, Asmitha Ltd. incurred ₹ 2,00,000, net loss from disposal ofa business segment. Also, on 31st July, 2021, the company paid ₹ 60,000 for property taxes assessed for the calendar year 2021. 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, 2021.

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, 2021, 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 2021, ₹ 30,000 would be reported as an expense for six months ended on 30th September, 2021 while out of the remaining ₹ 30,000, ₹ 15,000 for January, 2021 to March, 2021 should be shown as payment of the outstanding amount of previous year and another ₹ 15,000 related to quarter October, 2021 to December, 2021 would be reported as prepaid expenses.

Question 5 *(ICAI Study Material)*

Chp Sep 26

Antarbarti Limited reported a Profit Before Tax (PBT) of ₹ 4 lakhs for the third quarter ending 30-09-2021. On enquiry you observe the following. Give the treatment required under AS 25:

a. Dividend income of ₹ 4 lakhs received during the quarter has been recognized to the extent of ₹ 1 lakh only.
b. 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.
c. 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.
d. ₹ 2 lakhs extra-ordinary gain received in third quarter was allocated equally to the third and fourth quarter.
e. 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.
f. 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 financialyear. 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 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)**

Question 6 *(ICAI Study Material)*

The accounting year of X Ltd. ends on 30th September, 2021 and it makes its reports quarterly. However, for the purpose of tax, year ends on 31st March every year. For the Accounting year from 1-10-2020 to 30-9-2021, the quarterly income is as under:

1st quarter ending on 31st December, 2020	₹ 200 crores
2nd quarter ending on 31st March, 2021	₹ 200 crores
3rd quarter ending on 30th June, 2021	₹ 200 crores
4th quarter ending on 30th September, 2021	₹ 200 crores
Total	**₹ 800 crores**

Average actual tax rate for the financial year ending on 31st March, 2021 is 20% and for financial year ending 31st March, 2022 is 30%.

Calculate tax expense for each quarter.

Question 7 *(ICAI Study Material)*

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 & ₹ 3,00,000. Calculate the tax expense to be recognized in each quarter.

Question 8

Narayan Ltd. provides you the following information and asks you to calculate the tax expense for each quarter with reference to AS 25, assuming that there is no difference between the estimated taxable income and the estimated accounting income:
Estimated Annual Income ₹ 33,00,000 (inclusive of Estimated Capital Gains of ₹ 8,00,000)
Estimated Income of
Quarter I is ₹ 7,00,000,
Quarter II is ₹ 8,00,000,
Quarter III (including Estimated Capital Gains of ₹ 8,00,000) is ₹ 12,00,000 and
Quarter IV is ₹ 6,00,000.

Tax Rates:	On Capital Gains 12%		
	On Other Income:	First ₹ 5,00,000	30%
		Balance Income	40%

Question 9 *(ICAI Study Material)*

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 thatfinancial year?

Solution

As per AS 25, the principles for recognising and measuring losses from inventorywrite-downs, restructurings, or impairments in an interim period are the same asthose 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 financialyear, the original estimate is changed in the subsequent interim period either byaccrual of an additional amount of loss or by reversal of the previously recognised amount. In light of the same, the impairment loss recognized in onequarter 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.

Question 10 *(ICAI Study Material)*

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 othersignificant one-time events.

PRACTICE QUESTIONS

Question 1 *(ICAI Study Material)*

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 20%

For the First quarter ending 30th June, 2021, 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, 2021

			(₹ in crores)
Turnover			50
Add: Other Income			Nil
Total			50
Less: Change in inventories		Nil	
Salaries and other cost		30	
Administrative and selling expenses	(8 + 2)	10	40
Profit			10

As per AS 25 on Interim Financial Reporting, the income and expense should be recognized when they are earned and incurred respectively. As per AS 25, the costs should be anticipated or deferred only when

i. it is appropriate to anticipate that type of cost at the end of the financial year,and
ii. costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of ₹ 21 crores is not tenable as expenditures are uniform throughout all quarters.

Question 2 *(ICAI Study Material)*

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, 2021. The Financial Year is FY 2021-22.

Solution

As per Accounting Standard 25, Interim reports should include interimfinancial 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 interimfinancial statements for the period ended and as at 31st December, 2021:

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 2021 and 31 March 2021).
Statements of Profit and Loss	For the current interim period and cumulatively for the current financial year to date, with comparative statements ofprofit 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 2021 and same for 31 December 2020 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 2021 to 31 December 2021 and 1 April 2020to 31 December 2020).

INTANGIBLE ASSETS

AS 26

Objective	❖ To prescribe accounting treatment & recognition criterion for intangible assets ❖ It also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets
Non-Applicability	❖ Intangible assets that are covered by another Accounting Standard • Held by an enterprise for sale in ordinary course of business (AS-2) • Deferred tax assets AS-22 • Leases that fall within the scope of AS-19 • Goodwill arising on amalgamation AS-14 • Goodwill arising on consolidation AS-21 ❖ Financial assets ❖ Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and ❖ Intangible assets arising in insurance enterprises from contract with policy holders.
Monetary assets	Realizable for fixed or determinable sum under contract (assets that can be easily converted into a fixed amount of money in the immediate short term) **Example** – Debtors, Bills receivables, etc.
Non Monetary assets	No Fixed amount under contract (not readily converted into a fixed amount of money in the short term) **Example-** Goodwill, Patterns, Trade mark, Copyrights, PPE etc.
Meaning of intangible asset-	It is an → Identifiable → Non monetary asset → Without any physical substance → Held for economic benefits i.e. either for use in production or supply of goods or services, for rental to others or for administrative purposes. → Under the control of entity
Essential components	❖ It must be identifiable i.e the asset must be separable from other assets. ❖ It must be controlled by the enterprise ❖ Future economic benefits must be associated with an intangible asset
Recognition of Intangible asset	An intangible asset should be recognized if and only if → It meets all the essential elements of an intangible assets → It is probable that future economic benefits will flow to the enterprise → Cost of the asset can be measured reliably. Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise as employees may leave the enterprise anytime or even loyal customers may decide to purchase goods and services from other suppliers. Hence, these items don't even qualify as intangible asset as per the definition given in AS 26

MEASUREMENT OF INTANGIBLE ASSETS

Procurement /Separate Acquisition

Cost of Intangible Assets include the following:

Purchase price (net of trade discount & rebates)	XX
Add: Non-refundable taxes & duties	XX
Add: Directly attributable expenditure on making the asset ready for its intended use*	XX
Cost of Asset	**XX**

*__Example__: Professional fees for legal services

In Exchange for Another Asset or Shares/Other Securities

Cost of Intangible Asset is

- Fair Market Value (FMV) of Asset given / Securities issued

or

- Fair Market Value (FMV) of the Asset acquired

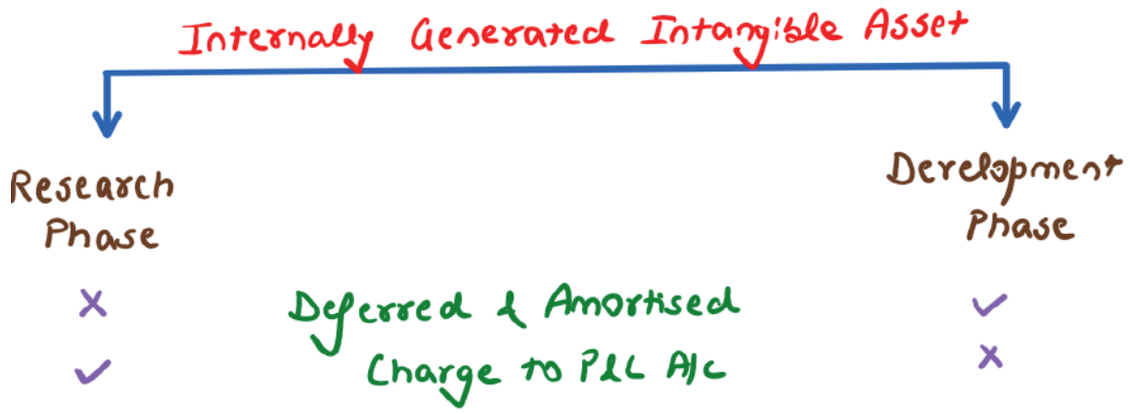
whichever is more clearly evident.

__Note:__ (a) FMV of the shares /securities to be considered & not Book value
(b) Such value is to be seen on the date of transaction

Acquisition By Way of Government Grant

Given at concessional rate	On the basis of their acquisition costs
Given free of cost	Record at nominal value

This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences, etc.



__Development Phase:__

Amount Capitalised = Lower of Cost or Recoverable Amount

Where Recoverable amount = Present value of Future Cash Flows

→ If an enterprise __cannot distinguish__ the research phase from the development phase to create an intangible asset, the expenditure should be treated as if it were incurred in the __research phase__ only.

→ Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

→ Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Examples of research activities are: ***(Research: Acquisition of Knowledge)***

a) Activities aimed at obtaining new knowledge.
b) Search for evaluation & final selection of, applications of research findings/other knowledge
c) Search for alternatives for materials, devices, products, processes, systems or services
d) The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Examples of development activities are: ***(Development: Application of Knowledge)***

a) The design, construction & testing of pre-production or pre-use prototypes and models.
b) The design of tools, jigs, moulds and dies involving new technology.
c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and
d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Development phase (PARA 44)	An intangible asset arising from development should be recognized if and only if an enterprise can demonstrate **all** of the following: ❖ Technical feasibility established ❖ Marketability proved (How intangible asset will generate future economic benefits i.e. existence of market for its output, its usefulness etc.) ❖ Identification of cost incurred ❖ Availability of adequate technical, financial & other resources to complete ❖ Intention to complete the asset and use or sell it.
Cost of an Internally Generated Intangible Asset	The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The following are **not components of the cost** of an internally generated intangible asset: ➢ Selling, administrative & other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use. ➢ Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and ➢ Expenditure on training the staff to operate the asset
Recognition of an expense	Expenditure on an intangible item should be recognized as an expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria. **Examples** of other expenditure that is recognised as an expense when it is incurred include: ➢ expenditure on advertising and promotional activities; ➢ expenditure on training activities; ➢ expenditure on start-up activities (start-up costs), open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes, etc. ➢ expenditure on relocating or re-organising part or all of an enterprise. **Note:** Expenditure on an intangible item that was initially recognised as an expense in previous annual financial statements should not be recognised as part of the cost of an intangible asset at a later date.

Subsequent Expenditure	Subsequent expenditure on an intangible asset after its purchase or its completion should be **recognised as an expense** when it is incurred **unless:** → it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and → the expenditure can be measured and attributed to the asset reliably. If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.
AMORTISATION PERIOD (PARA 63)	
Basis of allocation	Depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life.
Presumption as to the useful life	It **will not exceed 10 years** from the date when the asset is available for use unless there is persuasive evidence that intangible asset has higher useful life.
When should it commence?	Amortisation should commence when asset is available for use.
Notes	Given the history of rapid changes in technology, computer software and other intangible asset is susceptible to technological obsolescence, it is likely that useful life of the software etc. will be much shorter, say 3-5 years
AMORTISATION METHOD	
Which method to follow	❖ The method used should reflect the pattern in which assets economic benefits are consumed by enterprise (In the ratio of future cash flows) ❖ If that pattern cannot be determined reliably, the SLM should be used.

REVIEW OF AMORTISATION PERIOD AND METHOD

The amortisation period and method should be reviewed at least at each financial year end. In there is change in useful life or change in the expected pattern of economic benefits then amortisation period and method should be changed respectively.
Such changes should be accounted for in accordance with AS 5 (Prospective Effect)

RECOVERABILITY OF THE CARRYING AMOUNT-IMPAIRMENT LOSSES

Impairment losses of intangible assets are calculated on the basis of AS 28.
Impairment Loss = Carrying Amount – Recoverable Amount

An enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end:
(a) an intangible asset that is not yet available for use; and
(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

Example:
X limited is developing a customized software for ₹ 10 Cr. It will take 3 years to complete development. The present value of future economic benefit is considered to be ₹ 15 Cr. After 2 years, 70% work is completed. However, due to change in market conditions, present value of future economic benefits are estimated to be ₹ 6 Cr only.

Company should recognize ₹ 1 Cr as impairment loss on "Intangible asset under development" as per AS 28. Only ₹ 6 Cr can be shown as "Intangible asset under development". Company cannot capitalize any further amount till the time recoverable amount increases even if work of ₹ 10 Cr is completed.

DERECOGNITION OF INTANGIBLE ASSETS i.e. RETIREMENT & DISPOSAL	
When to Derecognize?	Intangible asset should be derecognized (eliminated from balance sheet) → on disposal or → when no future economic benefits are expected from its use & subsequent disposal.
Treatment	Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.
DISCLOSURE REQUIREMENTS	
General Disclosures	The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets: 1. The useful lives or the amortization rates used. 2. The amortization methods used. 3. The gross carrying amount & the accumulated amortization (aggregated with accumulated impairment losses) at the beginning & end of period. 4. Reconciliation of carrying amount at beginning & end of period showing: • Additions, indicating separately those from internal development and through amalgamation. • Retirements and disposals. • Amortisation recognised during the period and • Other changes in the carrying amount during the period.
Other Disclosures	The financial statements should also disclose: ➢ If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset. ➢ A description, the carrying amount and remaining amortization period of any individual intangible asset that is material to the financial statements of the enterprise as a whole. ➢ The existence & carrying amounts of intangible assets whose title is restricted & carrying amounts of intangible assets pledged as security for liabilities and ➢ The amount of commitments for the acquisition of intangible assets. ➢ The financial statements should disclose aggregate amount of research & development expenditure recognised as an expense during the period.

ASSIGNMENT QUESTIONS

Question 1

*Pg no.*_____

A company acquired for its internal use a software on 28.01.2020 from the USA for US $ 1,00,000. The exchange rate on that date was ₹ 52 per USD. The seller allowed trade discount @ 5 %. The other expenditure were:

a) Import Duty: 20%
b) Purchase Tax: 10%
c) Entry Tax: 5 % (Recoverable later from tax department)
d) Installation expenses: ₹ 25,000
e) Profession fees for Clearance from Customs: ₹ 20,000

Compute the cost of Software to be capitalized.

Question 2

*Pg no.*_____

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 & 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 3 *(RTP May 2020) (Similar)*

*Pg no.*_____

An enterprise acquired patent right for ₹ 400 lakhs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of estimated future cash flows which are as under:

Years	Estimated Future Cash Flows (₹ in lakhs)
1	200
2	200
3	200
4	100
5	100

After 3rd year, it was ascertained that the patent would have an estimated balance future life of 3 years and the estimated cash flow after 5th year is expected to be ₹ 50 lakhs.
Determine the amortization under Accounting Standard 26.

Question 4 *(ICAI Study Material)*

*Pg no.*_____

Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at ₹ 10,00,000 per annum. The company had amortized the patent at 10,00,000 per annum in first two years on the basis of economic benefits derived from the product manufactured under the patent After two years it was found that the product life-cycle may continue for another 5 years from then. The patent was renewable and Swift Ltd. got it renewed after expiry of five years. The net cash flows from the product during these 5 years were expected to be ₹ 36,00,000, ₹ 46,00,000, ₹ 44,00,000, ₹ 40,00,000 and ₹ 34,00,000.
Find out the amortization cost of the patent for each of the years.

Question 5

Pg no._____

NDA Corporation is engaged in research on a new process design for its product. It had incurred an expenditure of ₹ 530 lakhs on research upto 31st March, 2019. The development of the process began on 1st April, 2019 and Development phase expenditure was ₹ 360 lakhs upto 31st March, 2020 which meets assets recognition criteria. From 1st April, 2020, 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:

1) Accounting treatment for research expenses.
2) Cost of internally generated intangible asset as per AS 26.
3) Amount of amortization of assets. (Present value of annuity factor of Re. 1 for 5 years@10%=3.7908)

Question 6

Pg no._____

K. International Ltd. is developing a new production process. During the financial year ending 31st March, 2019, the total expenditure incurred was ₹ 50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2018. Expenditure incurred till this date was ₹ 22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2020 was ₹ 80 lakhs. As at 31st March, 2020, the recoverable amount of know-how embodied in the process is estimated to be ₹ 72 lakhs. This includes estimates of future cash outflows as well as inflows. You are required to calculate:

(i) Amount to be charged to Profit & Loss A/c for the year ending 31st March, 2019 and carrying value of intangible as on that date.
(ii) Amount to be charged to Profit & Loss A/c and carrying value of intangible as on 31st March, 2020

Ignore depreciation.

Question 7 *(RTP May 2021) / (RTP May 2024)*

Pg no._____

Naresh Ltd. had the following transactions during the financial year 2019-2020:

(i) Naresh Ltd. acquired running business of Sunil Ltd. for ₹ 10,80,000 on 15th May, 2019. The fair value of Sunil Ltd.'s net assets was ₹ 5,16,000. Naresh Ltd. is of the view that due to popularity of Sunil Ltd.'s product in the market, its goodwill exists.
(ii) Naresh Ltd. had taken a franchise on July 2019 to operate a restaurant from Sankalp Ltd. for ₹ 1,80,000 & at an annual fee of 10% of net revenues (after deducting expenditure). The franchise expires after 6 years. Net revenues were ₹ 60,000 during financial year 19-20.
(iii) On 20th August, 2019, Naresh Ltd, incurred costs of ₹ 2,40,000 to register the patent for its product.

Naresh Ltd. expects the patent's economic life to be 8 years. Naresh Ltd. follows an accounting policy to amortize all intangibles on straight line basis over the maximum period permitted by accounting standards taking a full year amortization in the year of acquisition. Goodwill on acquisition of business to be amortized over 5 years (SLM) as per AS 14.

Prepare a schedule showing the intangible assets section in Naresh Ltd. Balance Sheet at 31st March, 2020.

Question 8 *(ICAI Study Material)*

Pg no._____

ABC Ltd. developed know-how by incurring expenditure of ₹ 20 lakhs, The know-how was used by the company from 1.4.2013. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.2020.

Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.2020.

Question 9

Pg no._____

Base Limited is showing an intangible asset at ₹ 85 lakhs as on 1-4-2020. This asset was acquired for ₹ 112 lakhs on 1-4-2017 and the same was available for use from that date. The company has been following the policy of amortization of the intangible asset over a period of 12 years on straight line basis. Comment on the accounting treatment of the above with reference to the relevant accounting standard.

Solution

As per para 63 of 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, Base Limited would be required to restate carrying amount of intangible asset as on 1.4.2020 at ₹ 112 lakhs less ₹ 33.6 lakhs {112 lakhs/10 years ×3 years} = ₹ 78.4 lakhs.

The difference of ₹ 6.6 lakhs i.e. (₹ 85 lakhs – ₹ 78.4 lakhs) will be adjusted against the opening balance of revenue reserve. The carrying amount of ₹ 78.4 lakhs would be amortized over remaining 7 years by ₹ 11.2 lakhs per year.

Question 10

Pg no._____

On 31-03-2020, the Balance Sheet of Alpha Ltd. shows an item of Intangible assets at ₹ 30 Lakhs. The asset was acquired on 1-4-2015 for ₹ 80 lakhs and was available for use on that date. The company has been following a policy of amortizing intangible assets over a period of 8 years on straight line basis. How you will deal in the books of accounts if the company determines by applying the best estimate of its useful life on 1-4-2020, and the amortization period to be 10 years, being the best estimate of its useful life from the date, it was available for use.

Solution

As per AS 26 'Intangible Assets', the depreciable amount of an intangible asset should be allocated on a systematic basis over its useful life. Also there is a rebuttable presumption that the useful life of an intangible asset will not exceed 10 years from the date it is available for use. The amortization should commence when the asset is available for use. As per AS 26, if there has been a significant change in the expected pattern of economic benefits from the asset, the amortization method should be changed to reflect the changed pattern.

The company has been following a policy of amortization over a period of 8 years. As on 01-4-2020, 5 years have passed and the carrying amount stands at ₹ 30 lakhs. If the same treatment were to be continued, this would have been amortized over the next 3 years. But the revised estimate of remaining useful life would extend the period by another 5 years to amortize the carrying amount, the Company would be advised to amortize the carrying value over the next 5 years.

Thus, after revision in estimated useful life, the amount of ₹ 30 lacs would be amortised over next 5 years (i.e. ₹ 30 Lacs/5= ₹ 6 lacs every year)

Question 11 *(ICAI Study Material)* *Pg no._____*

AB Ltd. launched a project for producing product X in October, 2019. The Company incurred ₹ 20 lakhs towards Research. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years. Advise the Company as per the applicable Accounting Standard.

Solution

As per AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard.

Hence, the expenses amounting ₹ 20 lakhs incurred on the research has to be charged to the statement of profit and loss in the current year ending 31st March, 2020.

Question 12 *(Inter Nov 2019) (5 Marks) / (RTP May 2023) / (ICAI Study Material)* *Pg no._____*

As per provisions of AS-26, how would you deal to the following situations:

(1) ₹ 23,00,000 paid by a manufacturing company to the legal advisor for defending the patent of a product is treated as a capital expenditure.

(2) During the year 2018-19, a company spent ₹ 7,00,000 for publicity and research expenses on one of its new consumer product which was marketed in the same accounting year but proved to be a failure.

(3) A company spent ₹ 25,00,000 in the past three years to develop a product, these expenses were charged to profit and loss account since they did not meet AS-26 criteria for capitalization. In the current year approval of the concerned authority has been received. The company wishes to capitalize ₹ 25,00,000 by disclosing it as a prior period item.

(4) A company with a turnover of ₹ 200 crores and an annual advertising budget of ₹ 50,00,000 had taken up for the marketing of a new product by a company. It was estimated that the company would have a turnover of ₹ 20 crore from the new product. The company had debited to its Profit & Loss Account the total expenditure of ₹ 50,00,000 incurred on extensive special initial advertisement campaign for the new product

Solution

As per AS 26 "Intangible Assets", subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense when it is incurred unless

a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

b) expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

(1) In the given case, the legal expenses to defend the patent of a product amounting ₹ 23,00,000 should not be capitalized and be charged to Profit and Loss Statement.

(2) The company is required to expense the entire amount of ₹ 7,00,000 in the Profit and Loss account for the year ended 31st March, 2019 because no benefit will arise in the future.

(3) As per AS 26, expenditure on an intangible item that was initially recognized as an expense by a reporting enterprise in previous annual financial statements should not be recognized as part of the cost of an intangible asset at a later date. Thus the company cannot capitalize the amount of ₹ 25,00,000 and it should be recognized as expense

(4) Expenditure of ₹ 50,00,000 on advertising and promotional activities should always be charged to Profit and Loss Statement. Hence, the company has done the correct treatment by debiting the sum of 50 lakhs to Profit and Loss Account.

Question 13 *(RTP May 2022)* *Pg no._____*

(a) PQR Ltd. has acquired a Brand from another company for ₹ 100 lakhs. PQR Ltd. contends that since the said brand is a very popular and famous brand, no amortization needs to be provided. Comment on this in line with the Accounting Standards.

(b) X Ltd. is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During the year ended 31st March, 2021, it incurred substantial amount on business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefit by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the accountant of the company do you concur with these views? You are required to explain in line with provisions of Accounting Standards.

Solution

(a) AS 26 'Intangible Assets" provides that an intangible asset should be measured initially at cost. After initial recognition, an intangible asset should be carried at cost less any accumulated amortization and any accumulated impairment losses. The amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life for computing amortization. There is a rebuttable presumption that the useful life of an intangible asset will not exceed 10 years from the date when the asset is available for use. It must be ensured that the value of brand is amortized in accordance with AS 26, as brand is considered to be intangible asset. The contention of PQR Ltd. that Brand is very popular and famous, hence no amortization needs to be provided is not correct as there is no persuasive evidence that the useful life of the intangible asset will exceed 10 years.

(b) As per AS 26 on Intangible Assets, expenditure on an intangible item should be recognized as on expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria. An intangible asset should be recognized if, & only if:

(i) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(ii) the cost of the asset can be measured reliably.

In the given case, no intangible assets or other asset is acquired or created that can be recognized, the accounting treatment by the company to amortize the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the profit and loss statement during the year ended 31st March, 2021.

Question 14 *(ICAI Study Material)* *Pg no._____*

During 2019-20, an enterprise incurred costs to develop and produce a routine low risk computer software product, as follows:

	Amount (₹)
Completion of detailed programme and design (Phase 1)	50,000
Coding and Testing (Phase 2)	40,000
Other coding costs (Phase 3 & 4)	63,000
Testing costs (Phase 3 & 4)	18,000
Product masters for training materials (Phase 5)	19,500
Packing the product (1,500 units) (Phase 6)	16,500

After completion of phase 2, it was established that the product is technically feasible for the market. You are required to state how the above referred cost to be recognized in the books of accounts

Solution

As per AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed program design, coding and testing.

In this case, ₹ 90,000 would be recorded as an expense (₹ 50,000 for completion of detailed program design and ₹ 40,000 for coding and testing to establish technological feasibility/asset recognition criteria).

Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (63,000+ 18,000+ 19,500) = ₹ 1,00,500. Packing cost ₹ 16,500 should be recognized as expenses and charged to P & L A/c.

PRACTICE QUESTIONS

Question 1 *(Inter Jan 2021) (5 Marks)* Pg no._____

A Company acquired for its internal use a software on 01.03.2020 from U.K. for £ 1,50,000. The exchange rate on the date was as ₹ 100 per £. The seller allowed trade discount @ 2.5%. The other expenditures were:

(i) Import Duty 10%
(ii) Additional Import Duty 5%
(iii) Entry Tax 2% (Recoverable later from tax department).
(iv) Installation expenses ₹ 1,50,000.
(v) Professional fees for clearance from customs ₹ 50,000.

Compute the cost of software to be Capitalized as per relevant AS

Solution

Calculation of cost of software (intangible asset) acquired for internal use

	Amount
Purchase cost of the software (UK £)	1,50,000
Less: Trade discount @ 2.5% (UK £)	(3,750)
	1,46,250
Cost in ₹ (UK £1,46,250 x ₹ 100)	1,46,25,000
Add: Import duty on cost @ 10% (₹)	14,62,500
	1,60,87,500
Add: Additional import duty @ 5% (₹)	8,04,375
	1,68,91,875
Add: Installation expenses (₹)	1,50,000
Add: Professional fee for clearance from customs (₹)	50,000
Cost of the software to be capitalized (₹)	**1,70,91,875**

Note: Since entry tax has been mentioned as a recoverable / refundable tax, it is not included as part of the cost of the asset

Question 2 *(Inter Nov 2020) (5 Marks) / (RTP Nov 2023)* Pg no._____

Swift Limited acquired patent rights to manufacture Solar Roof Top Panels at a cost of ₹ 600 lacs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of future cash flows which are estimated as under:

Year	1	2	3	4	5
Cash Flows (₹ in lacs)	300	300	300	150	150

After 3rd year, it was estimated that the patents would have an estimated balance future life of 3 years and Swift Ltd. expected the estimated cash flow after 5th year to be ₹ 75 Lacs. Determine the amortization cost of the patent for each of the above years as per AS 26.

Solution

Amortization of cost of Patent as per AS 26

Year	Estimated future cash flow (₹ in lakhs)	Amortization Ratio	Amortized Amount (₹ in lakhs)
1	300	.25	150
2	300	.25	150
3	300	.25	150
4	150	.10	60
5	150	.10	60

6	75	.05	30
		1.00	**600**

In the first three years, the patent cost will be amortized in the ratio of estimated future cash flows i.e. (300: 300: 300: 150: 150). The unamortized amount of the patent after third year will be ₹ 150 lakh (600-450) which will be amortized in the ratio of revised estimated future cash flows (150:150:75 or 2:2:1) in the fourth, fifth and sixth year.

Question 3 *(RTP Nov 2018)* *Pg no.*_____

Desire Ltd. acquired a patent at a cost of ₹ 1,00,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset on SLM. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be ₹ 45,00,000, ₹ 42,00,000, ₹ 40,00,000, ₹ 38,00,000 and ₹ 35,00,000. Patent is renewable and company changed amortization method from 3rd year (i.e. from SLM to ratio of expected new cash flows). You are required to compute the amortization cost of the patent for each of the years (1st year to 7th year).

Solution

Desire Limited amortised ₹ 20,00,000 per annum for the first two years i.e. ₹ 40,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortization may be found as follows

Year	Net cash flows	Amortization Ratio	Amortization Amount
1	-	0.200	20,00,000
2	-	0.200	20,00,000
3	45,00,000	0.225	13,50,000
4	42,00,000	0.210	12,60,000
5	40,00,000	0.200	12,00,000
6	38,00,000	0.190	11,40,000
7	35,00,000	0.175	10,50,000
Total	**2,00,00,000**	**1.000**	**1,00,00,000**

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 60,00,000 has been amortized in the ratio of net cash flows arising from the product of Desire Ltd

Question 4 *(Inter May 2018) (5 Marks)* *Pg no.*_____

A company acquired a patent at a cost of ₹ 160 lakhs for a period of 5 years and the product life cycle is also 5 years. The company capitalized the cost and started amortising the asset at ₹ 16 lakhs per year based on the economic benefits derived from the product manufactured under the patent. After 2 years it was found that the product life cycle may continue for another 5 years from then (the patent is renewable and the company can get it renewed after 5 years). The net cash flows from the product during these 5 years were expected to be ₹ 50 lakhs, ₹ 30 lakhs, ₹ 60 lakhs, ₹ 70 lakhs and ₹ 40 lakhs. Find out the amortization cost of the patent for each of the years.

Solution

Company amortized ₹ 16,00,000 per annum for the first two years. Hence, Amortization for the first two years (₹ 16,00,000 X 2) = ₹ 32,00,000.

Remaining carrying cost after two years =₹ 1,60,00,000 – ₹ 32,00,000 = ₹ 1,28,00,000

Since after two years it was found that the product life cycle may continue for another 5 years, hence the remaining carrying cost ₹128 lakhs will be amortized during next 5 years in the ratio of net cash arising from the sale of the products of Fast Limited.

The amortization cost of the patents may be computed as follows:

Year	Net cash flows	Amortization Ratio	Amortization Amount
1	-	0.1	16,00,000
2	-	0.1	16,00,000
3	50,00,000	0.2	25,60,000
4	30,00,000	0.12	15,36,000
5	60,00,000	0.24	30,72,000
6	70,00,000	0.28	35,84,000
7	40,00,000	0.16	20,48,000
Total	**2,50,00,000**	**1.000**	**1,60,00,000**

Question 5 *(Inter Nov 2023) (5 Marks)* *Pg no._____*

Panna Limited purchased software from Agate Limited for a period of 5 years and capitalized the cost. It provided you the following information:

- Cost of software ₹ 57,60,000.
- Expected Life cycle of the software 5 years

The software was amortized at ₹ 6,40,000 per annum in first three years based on economic benefits derived from the software. After three years, it was found that the software may be used for another 5 years from then. So, Panna Limited got it renewed after expiry of five years for 3 more years.

The net cash flows from the software during these 5 years were expected to be as follows:

Particular	Amount (₹)
Year 1	₹ 23,04,000
Year 2	₹ 29,44,000
Year 3	₹ 28,16,000
Year 4	₹ 25,60,000
Year 5	₹ 21,76,000

You are required to calculate the amortization cost of the software for each of the years.

Solution

Panna Limited amortised ₹ 6,40,000 per annum for the first three years i.e. ₹ 19,20,000. The remaining carrying cost can be amortised during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

Year	Net cash flows ₹	Amortisation Ratio	Amortisation Amount ₹
I	-	0.1111	6,40,000
II	-	0.1111	6,40,000
III	-	0.1111	6,40,000
IV	23,04,000	0.180	6,91,200
V	29,44,000	0.230	8,83,200
VI	28,16,000	0.220	8,44,800
VII	25,60,000	0.200	7,68,000
IX	21,76,000	0.170	6,52,800
Total	**1,28,00,000**	**1.000**	**57,60,000**

It may be seen from above that from fourth year onwards, the balance of carrying amount i.e., ₹ 38,40,000 has been amortised in the ratio of net cash flows arising from the product of Panna Ltd.

Question 6

Pg no._____

Plymouth Ltd. is engaged in research on a new process design for its product. It had incurred ₹ 10 lakh on research during first 5 months of the financial year 2019-20. The development of the process began on 1st September, 2019 and upto 31st March, 2020, a sum of ₹ 8 lakh was incurred as Development Phase Expenditure, which meets assets recognition criteria.
From 1st April, 2020, the Company has implemented the new process design and it is likely that this will result in after tax saving of ₹ 2 lakh per annum for next five years.
The cost of capital is 10%. The present value of annuity factor of ₹ 1 for 5 years @ 10% is 3.7908.
Decide the treatment of Research and Development Cost of the project as per AS 26.

Solution

Research Expenditure – According to AS 26 'Intangible Assets', the expenditure on research of new process design for its product ₹ 10 lakhs should be charged to Profit and Loss Account in the year in which it is incurred. It is presumed that the entire expenditure is incurred in the financial year 2019-20. Hence, it should be written off as an expense in that year itself.
Cost of internally generated intangible asset – it is given that development phase expenditure amounting ₹ 8 lakhs incurred upto 31st March, 2020 meets asset recognition criteria. As per AS 26, for measurement of such internally generated intangible asset, fair value should be estimated by discounting estimated future net cash flows.

Savings (after tax) from implementation of new design for next 5 years	2 Lakhs p.a.
Company's cost of capital	10%
Annuity factor @ 10% for 5 years	3.7908
Present value of net cash flows (₹ 2 lakhs x 3.7908)	7.582 Lakhs

The cost of an internally generated intangible asset would be lower of cost value ₹ 8 lakhs or present value of future net cash flows ₹ 7.582 lakhs.
Hence, cost of an internally generated intangible asset will be ₹ 7.582 lakhs.
The difference of ₹ 0.418 lakhs (i.e. ₹ 8 lakhs – ₹ 7.582 lakhs) will be amortized by Plymouth for the financial year 2019-20.
Amortisation - The company can amortize ₹ 7.582 lakhs over a period of five years by charging ₹ 1.516 lakhs per annum from the financial year 2020-2021 onwards

Question 7 *(Inter Nov 2020) (5 Marks)*

Pg no._____

M/s. Pasa Ltd. is developing a new production process. During the financial year ended 31st March, 2019, the total expenditure incurred on the process was ₹ 80 lakhs. The production process met the criteria for recognition as an intangible asset on 1 st November, 2018. Expenditure incurred till this date was ₹ 42 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2020 was ₹ 90 lakhs. As on 31.03.2020, the recoverable amount of know how embodied in the process is estimated to be ₹ 82 lakhs. This includes estimates of future cash outflows and inflows.
You are required to work out:

(1) What is the expenditure to be charged to Profit and Loss Account for the year ended 31st March, 2019?
(2) What is the carrying amount of the intangible asset as on 31st March, 2019?
(3) What amount of expenditure to be charged to Profit and Loss Account for the year ended 31st March, 2020?
(4) What is the carrying amount of the intangible asset as on 31st March, 2020?

Solution

As per AS 26 'Intangible Assets'

(i) **Expenditure to be charged to Profit and Loss account for the year ending 31.03.2019**
₹ 42 lakhs is recognized as an expense because the recognition criteria were not met until 1st November, 2018. This expenditure will not form part of the cost of the production process recognized as an intangible asset in the balance sheet.

(ii) **Carrying value of intangible asset as on 31.03.2019**
At the end of financial year, on 31st March 2019, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 38 (80-42) lakhs (expenditure incurred since the date the recognition criteria were met, i.e., from 1 st November 2018)

(iii) **Expenditure to be charged to Profit and Loss account for the year ended 31.03.2020**

	(₹ in lacs)
Carrying Amount as on 31.03.2019	38
Expenditure during 2019 – 2020	90
Book Value	128
Recoverable Amount	(82)
Impairment loss	46

₹ 46 lakhs to be charged to Profit and loss account for the year ending 31.03.2020

(iv) **Carrying value of intangible asset as on 31.03.2020**

	(₹ in lacs)
Book Value	128
Less: Impairment loss	(46)
Carrying amount as on 31.03.2020	82

Question 8 *(Inter Dec 2021) (5 Marks)* *Pg no._____*

Surgical Ltd, is developing a new production process of surgical equipment. During the financial year ended 31st March 2020 the total expenditure incurred on the process was ₹ 67 lakhs. The production process met the criteria for recognition as an intangible asset on 1st January 2020. Expenditure incurred till this date was ₹ 35 lakhs. Further expenditure incurred on the process for the financial year ending 31st March 2021 ₹ 105 lakhs. As on 31st March 2021, the recoverable amount of technique embodied in the process is estimated to be ₹ 89 lakhs. This includes estimates of future cash outflows and inflows. Under the provisions of AS 26, you are required to ascertain:

(i) The expenditure to be charged to Profit & Loss Account for year ended 31st March 2020;
(ii) Carrying amount of the intangible asset as on 31st March 2020;
(iii) Expenditure to be charged to Profit and Loss Account for the year ended 31st March 2021;
(iv) Carrying amount of the intangible asset as on 31st March 2021.

Solution

As per AS 26 'Intangible Assets'

(i) **Expenditure to be charged to Profit and Loss account for the year ended 31.03.2020** ₹ 35 lakhs is recognized as an expense because the recognition criteria were not met until 1stJanuary 2020. This expenditure will not form part of the cost of the production process recognized as an intangible asset in the balance sheet.

(ii) **Carrying value of intangible asset as on 31.03.2020**
At the end of financial year, on 31st March 2020, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 32 (67-35) lacs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st January 2020).

(iii) **Expenditure to be charged to Profit and Loss account for the year ended 31.03.2021**

	(₹ in lacs)
Carrying Amount as on 31.03.2020	32
Expenditure during 2020 – 2021	105
Book Value	137
Recoverable Amount	(89)
Impairment loss	48

₹ 48 lakhs to be charged to Profit and loss account for the year ending 31.03.2021

(iv) **Carrying value of intangible asset as on 31.03.2021**

	(₹ in lacs)
Book Value	137
Less: Impairment loss	(48)
Carrying amount as on 31.03.2021	89

Question 9 *(Inter Sep 2024) (4 Marks)* *Pg no._____*

In the following cases, record Journal Entries for amortization in the books of Huge Ltd. for the year ended 31st March, 2024 with reference to AS-26:

(i) The company had acquired Patent Rights for ₹ 340 lakhs on 01.04.2022. The estimated product life is 4 years. Amortization was decided in the ratio of estimated future cash flows which are as under:

1st Year ₹ 140 Lakhs
2nd Year ₹ 350 Lakhs
3rd Year ₹ 280 Lakhs
4th Year ₹ 420 Lakhs

(ii) The company had developed know-how by incurring expenditure of ₹ 80 lakhs. The know-how has been used by the company since 01.04.2018. Its useful life is 8 years from the year of commencement of its use. The company has not amortised asset until 31.03.2024.

Solution

(i) **Journal Entry for the year ended on 31st March 2024**

			₹ in lakhs	₹ in lakhs
31.3.24	Amortization A/c (340 × 350/ 1,190)	Dr.	100	
	To Patent Rights A/c			100
	P&L A/c	Dr.	100	
	To Amortization A/c			100

Working note

Huge Limited amortised ₹ 340 lakhs during next 4 years on the basis of net cash flows arising of the product. The amortisation for second year will be worked out as under:

₹ 340 x 350 /1,190 (140+350+280+420) = ₹ 100 lakhs

(ii)

Particulars		₹ in lakhs	₹ in lakhs
Prior period item	Dr.	50	
Amortization A/c	Dr.	10	
To Know-how A/c			60
[Being amortization of 6 years (out of which amortization of 5 years charged as prior period item i.e. 80 x 6 /8 = 60 lakhs)]			
Profit and Loss A/c	Dr.	60	
To Amortization A/c			10
To Prior Period Item			50
(Being amount transferred to Profit and Loss account)			

Question 10 *(RTP Nov 2021)* *Pg no._____*

A company is showing an intangible asset at ₹ 88 lakhs as on 01.04.2020. This asset was acquired for ₹ 120 lakhs on 01.04.2016 and the same was available for use from that date. The company has been following the policy of amortization of the intangible assets over a period of 15 years on straight line basis. Comment on accounting treatment of the above with reference to relevant Accounting Standard.

Solution

As per para 63 of AS 26 'Intangible Assets', the depreciable amount of an intangible asset should be allocated on systematic basis over the best estimate of its useful life.

There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use.

Company has been following the policy of amortization of the intangible asset over a period of 15 years on straight line basis. The period of 15 years is more than the maximum period of 10 years specified as per AS 26.

Accordingly, the company would be required to restate the carrying amount of intangible asset as on 01.04.2020 at ₹ 72 lakhs i.e. ₹ 120 lakhs less ₹ 48 lakhs.

The difference of ₹ 16 Lakhs (₹ 88 lakhs – ₹ 72 lakhs) will be adjusted against the opening balance of revenue reserve. The carrying amount of ₹ 72 lakhs will be amortised over remaining 6 years by amortizing ₹ 12 lakhs per year.

The necessary journal entry (for rectification) will be

Revenue Reserves	Dr.	₹ 16 Lakhs
To Intangible Assets		₹ 16 Lakhs

(Adjustment to reserves due to restatement of the carrying amount of intangible asset)

Question 11 *(RTP May 2018) / (RTP Nov 2019) / (RTP Nov 2022)* *Pg no._____*

K Ltd. launched a project for producing product X in October, 2019. The Company incurred ₹ 40 lakhs towards Research and Development expenses upto 31st March, 2020. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years. Advise the Company as per the applicable Accounting Standard.

Solution

As per para 41 of AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions

specified in para 44 of the standard. An intangible asset (arising from development) should be derecognized when no future economic benefits are expected from its use according to para 87 of the standard. Thus, the manager cannot defer the expenditure write off to future years in the given case.

Hence, the expenses amounting ₹ 40 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2020.

Question 12 *Pg no._____*

A Pharma Company spent ₹33 lakhs during the accounting year ended 31st March, 2020 on a research project to develop a drug to treat "AIDS". Experts are of the view that it may take four years to establish whether the drug will be effective or not and even if found effective it may take two to three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment.

Solution

As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. Thus, the company cannot treat the expenditure as deferred revenue expenditure. The entire amount of ₹ 33 lakhs spent on research project should be charged as an expense in the year ended 31st March, 2020.

Question 13 *(ICAI Study Material)* *Pg no._____*

The company had spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 2019-2020, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2020.

Solution

In the given case, the company spent ₹ 45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/ benefit because of the failure of the product. Thus according to AS 26 'Intangible Assets', the company should charge the total amount of ₹ 45 lakhs as an expense in the profit and loss account.

Question 14 *(ICAI Study Material) / (RTP May 2019) (Similar)* *Pg no._____*

A company with a turnover of ₹ 250 crores and an annual advertising budget of ₹ 2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of ₹ 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of ₹ 2 crore incurred on extensive special initial advertisement campaign for the new product. Is the procedure adopted by company correct?

Solution

According to AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset". AS 26 mentions that expenditure on advertising and promotional activities should be recognised as an expense when incurred.

In the given case, advertisement expenditure of ₹ 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of ₹ 25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹ 2 crores to the Profit and Loss account of the year is correct.

Question 15 *(RTP Nov 2020)* *Pg no._____*

X Ltd. carried on business of manufacturing of Bakery products. The company has two trademarks "Sun" and "Surya". One month before, the company comes to know through one of the marketing managers that both trademarks have allegedly been infringed by other competitors engaged in the same field. After investigation, legal department of the company informed that it had weak case on trademark "Sun" and strong case in regard to trademark "Surya". X Ltd. incurred additional legal fees to stop infringement on both trademarks. Both trademarks have a remaining legal life of 10 years.

How should X Ltd. account for these legal costs incurred relating to the two trademarks?

Solution

As per AS 26 "Intangible Assets", subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense when it is incurred unless

a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

b) expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset. The legal costs incurred for both the trademarks do not enable them to generate future economic benefits in excess of its originally assessed standard of performance. They only ensure to maintain them if the case is decided in favour of the company. Therefore, such legal costs incurred for both trademarks must be recognized as an expense.

Question 16 *(RTP Jan 2025)* *Pg no._____*

During 2023-2024, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows:

	Amount (₹)
Completion of detailed programme and design (Phase 1)	25,000
Coding and Testing for establishing technical feasibility (Phase 2)	20,000
Other coding costs (Phase 3)	42,000
Testing costs (Phase 4)	12,000
Product masters for training materials (Phase 5)	13,000
Duplication of computer software and training materials, from product masters (2,000 units) (Phase 6)	40,000
Packing the product (1,000 units) (Phase 7)	11,000

After completion of phase 2, it was established that the computer software is technically feasible for the market. What amount should be capitalized as software costs in the books of the company, on the Balance Sheet date?

Solution

As per para 44 of AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed programme design or working model.

In this case, ₹ 45,000 would be recorded as an expense (₹ 25,000 for completion of detailed program design and ₹ 20,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (₹ 42,000 + ₹ 12,000 + ₹ 13,000) ₹ 67,000.

Duplication of computer software and training materials, from product masters and packing the products are the cost incurred after development phase. Hence, the same shall be expensed off during the year it is incurred.

FINANCIAL REPORTING OF INTEREST IN JOINT VENTURES

AS 27

Coverage	This standard set out principles and procedures for accounting of interests in joint venture and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors regardless of the structures or forms under which the joint venture activities take place. *The provisions of this AS need to be referred to for consolidated financial statement only when CFS is prepared and presented by the venturer.*	
Definitions	**Joint venture**	A contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control
	Joint control	It is the contractually agreed sharing of control over an economic activity
	Control	power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.
	Venturer	party to a joint venture and has joint control over that joint venture
	Investor	An investor in a joint venture is a party to a joint venture and does not have joint control over that joint venture.
Contractual Arrangement	The joint venture covered under this statement is governed on the basis of contractual agreement. Non-existence of contractual agreement will disqualify an organization to be covered in AS 27. Joint ventures with contractual agreement will be excluded from the scope of AS 27 only if the investment qualifies as subsidiary under AS 21, in this case, it will be covered by AS 21. Contractual agreement can be in the form of written contract, minutes of discussion between parties (venturers), articles of the concern or by-laws of the relevant joint venture. Irrespective of the form of the contract, the content of the contract ideally should include the following points: • The activity, duration and reporting obligations of the joint venture. • The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers. • Capital contributions by the venturers. • The sharing by the venturers of the output, income, expenses or results of the joint venture. If contractual agreement is signed by a party to safeguard its right, such agreement will not make the party a venturer. The contractual arrangement may identify one venturer as the operator or manager of the joint venture. **Example** IDBI gave loan to the joint venture entity of L&T and Tantia Construction, they signed an agreement according to which IDBI will be informed for all important decisions of the joint venture entity. This agreement is to protect the right of the IDBI, hence just signing the contractual agreement will not make investor a venturer.	

	Example Mr. A, M/s. B & Co. and C Ltd. entered into a joint venture, where according to the agreement, all the policies making decisions on financial and operating activities will be taken in a regular meeting attended by them or their representatives. Implementation and execution of these policies will be the responsibility of Mr. A. Here Mr. A is acting as venturer as well as manager of the concern. **Example** X Ltd invested ₹ 100 crore as initial capital along with Y Ltd and Z Ltd in GFH Ltd. The purpose of X Ltd making this investment is to grow the business of GFH Ltd along with the other investors. All investors have a right to attend to the meetings and to take decisions with respect to the business of GFH Ltd. All investors are actively involved in running the business of GFH Ltd and have a share in the returns generated by GFH Ltd in an agreed proportion. GFH Ltd is an example of a Joint Venture and X Ltd, Y Ltd and Z Ltd are all Venturers. Similarly, just because contractual agreement has assigned the role of a manager to any of the venturer will not disqualify him as venturer.
Forms of Joint Ventures	Joint ventures may take many forms and structures, this Statement identifies them in three broad types – **▪ Jointly Controlled Operations (JCO),** **▪ Jointly Controlled Assets (JCA) and** **▪ Jointly Controlled Entities (JCE).** Any structure which satisfies the following characteristics can be classified as joint ventures: (a) 2 or more venturers are bound by a contractual arrangement and (b) The contractual arrangement establishes joint control

Jointly Controlled Operations (JCO)

Under this set up, venturers do not create a separate entity for their joint venture business but they use their own resources for the purpose. They raise any funds required for joint venture on their own, they incur any expenses and sales are also realised individually.

Following are the key features of JCO:

a. Each venturer has his own separate business.
b. There is no separate entity for joint venture business.
c. All venturers are creating their own assets and maintain them.
d. Each venturer record only his own transactions without any separate set of books maintained for the joint venture business. All the transactions of joint venture are recorded in their books only.
e. There is a common agreement between all of them.
f. Venturers use their assets for the joint venture business.
g. Venturers met the liabilities created by them for the joint venture business.
h. Venturers met the expenses of the joint venture business from their funds.
i. Any revenue generated or income earned from the joint venture is shared by the venturers as per the contract.

Since the JCO is not purchasing assets or raising finance in its own right, the assets and liabilities used in the activities of the joint venture are those of the ventures. As such, they are accounted for in the financial statements of the venture to which they belong.
In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:
(a) the assets that it controls and the liabilities that it incurs; and
(b) the expenses that it incurs & its share of the income that it earns from the joint venture.
Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture. However, the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Example
Mr. A (dealer in tiles and marbles), Mr. B (dealer in various building materials) and Mr. C (Promoter) enters into a joint venture business, where any contract for construction received will be completed jointly, say, Mr. A will supply all tiles and marbles, Mr. B will supply other materials from his godown and Mr. C will look after the completion of construction. As per the contractual agreement, they will share any profit/loss in a predetermined ratio. None of them are using separate staff or other resources for the joint venture business and neither do they maintain a separate account. Everything is recorded in their personal business only.
Venturer doesn't maintain a separate set of books but they record only their own transactions of the joint venture business in their books. Any transaction of joint venture recorded separately is only for internal reporting purpose. Once all transactions recorded in venturer financial statement, they don't need to be adjusted for in consolidated financial adjustment.

Jointly Controlled Assets (JCA)

Separate legal entity is not created in this form of joint venture but venturer owns the assets jointly, which are used by them for the purpose of generating economic benefit to each of them. They take up any expenses & liabilities related to the joint assets as per the contract. Following points can be concluded:

- There is no separate legal identity.
- There is common control over the joint assets.
- Venturers use this asset to derive some economic benefit to themselves.
- Each venturer incurs separate expenses for their transactions.
- Expenses on jointly held assets are shared by the venturers as per the contract.
- In their financial statement, the venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.
- Since the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.
- Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Example
ABC Ltd., BP Ltd. and HP Ltd. having the same point of oil refinery and same place of customers agreed to spread a pipeline from their unit to customers place jointly. They agreed to share the expenditure on the pipeline construction and maintenance in the ratio 3:3:4 respectively and the time allotted to use the pipeline was in the ratio 4:3:3 respectively. For the joint venture, each venturer will record his share of joint assets as classified according to the nature of the assets rather than as an investment and any expenditure incurred or revenue generated will be recorded with other items similar to JCO.

Difference between JCO & JCA	❖ In JCO, venturers use their own assets for joint venture business but in JCA they jointly own the assets to be used in joint venture. ❖ JCO is an agreement to jointly carry on the operations to earn income whereas, JCA is an agreement to jointly construct and maintain an asset to generate revenue to each venturer. ❖ Under JCO all expenses and revenues are shared at an agreed ratio, in JCA only expenses on joint assets are shared at the agreed ratio.

Jointly Controlled Entities (JCE)

This is the format where a venturer creates a new entity for their joint venture business. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest.

The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.

All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity. The net result of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement.

Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in accounting records of the venturer and are recognised in its separate financial statements as an investment in the jointly controlled entity.

A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements applicable to that jointly controlled entity.

Example

A Ltd and B Ltd are two infrastructure companies operating in City A. The local authority has issued a tender to construct a metro stretch for 2,000 crore and had invited bidders to apply for the tender. A Ltd and B Ltd, jointly form a new entity AB Ltd that bids for the tender. All machinery and equipment will be the responsibility of A Ltd. All funding will be managed and controlled by B Ltd. Revenue and operating expenses will be shared jointly by A Ltd and B Ltd in the proportion of 60:40. In the above example AB Ltd constitutes a Jointly Controlled Entity (JCE).

Consolidated Financial Statements of a Venturer

Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Proportionate consolidation method is to be followed **except** in the following cases:

(a) Investment is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future. And

(b) joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

In both the above cases, investment of venturer in the share of the investee is treated as investment according to AS 13.

A venturer should ***discontinue*** the use of this method from the date that:

(a) It ceases to have joint control in the joint venture but retains, either in whole or in part, its investment.

(b) The use of the proportionate consolidation method is no longer appropriate because the joint venture operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

From the date of discontinuing the use of the proportionate consolidation method,

a) If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21.
b) If interest is 20% or more but upto 50%, investments are to be accounted for in accordance with AS 23.
c) For all other cases investment in joint venture is treated as per AS 13.
d) For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

Following are the features of Proportionate Consolidation Method:

- Stress is given on substance over form i.e., more importance is given to the share of venturers in the profit or loss of the venture from the share of assets and liabilities rather than the nature and form of the joint venture.
- Venturer's share of joint assets, liabilities, expenses and income are shown on the separate lines in the consolidated financial statement.
- Most of the provisions of Proportionate Consolidation Method are similar to the provisions of AS 21
- As far as possible the reporting date of the financial statements of jointly controlled entity and venturers should be same. If practically it is not possible to draw up the financial statements to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made in joint venturer's books for the effects of significant transactions or other events that occur between the jointly controlled entity's date and the date of the venturer's financial statements. In any case, the difference between reporting dates should not be more than six months.
- Accounting policies followed in the preparation of the financial statements of the jointly controlled entity and venturer should be uniform for like transactions and other events in similar circumstances. If accounting policies followed by venturer and jointly controlled entity are not uniform, then adjustments should be made in the items of the venturer to bring it in line with the accounting policy of the joint venture.
- Any asset or liability should not be adjusted by another liability or asset. Similarly any income or expense cannot be adjusted with another expense or income. Such adjustment can be made only when legally it is allowed to adjust them and such items does lead to settlement of obligation or writing off of assets.
- On the date when interest in joint entity is acquired, if the interest of venturer in net assets of the entity is less than the cost of investment in joint entity, the difference will be recognized as goodwill in the consolidated financial statement and if net asset is more than cost of investment, then the difference is recognized as capital reserve

Transactions between Venturer and Joint Venture

When venturer transfers or sells assets to Joint Venture, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss only when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

When the venturer from the joint venture purchases the assets, venturer will not recognized his share of profits in the joint venture of such transaction unless he disposes off the assets. A venturer should recognise his share of the losses resulting from these transactions in the same way as profits except that losses will be recognised in full immediately only when they represent a reduction in the net realisable value of current assets or an impairment loss.

In case the joint venture is in the form of separate entity (i.e., JCE) then provisions of above the Para will be followed only for consolidated financial statement and not for venturer's own financial statement. In the books of venturer, profit or loss from such transactions are recognised in full.

Example

A and B established a separate vehicle i.e. entity J, wherein each operator has a 50% ownership interest & each takes 50% of output. On formation of joint venture, A contributed a property with fair value of ₹ 110 crore & agreed to contribute his experience over the years towards this venture & B contributed equipment with fair value of ₹ 120 crore. The carrying values of the contributed assets were ₹ 100 crore and ₹ 80 crore, respectively.

Answer

A – Gain in consolidated financial statements

A's share in the fair value of assets contributed by entity B (50% × 120)	60
A's share in the carrying value of asset contributed by A to the joint venture (50% × 100)	(50)
Gain recognised by A	10

Other Points	The investors who don't have joint control over the entity recognized his share of net results and his investments in joint venture as per AS 13. In the consolidated financial statement, it is recognized as per AS 13, AS 21 or AS 23 as appropriate. Payment to operators is recognized as an expense in CFS and in the books of operators as per AS 9, Revenue Recognition. The operator may be any of the venturers, in this case any amount received by him, as management fees for the service will be recognized as stated above in this Para.
Disclosures	A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities: a. Any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers; b. Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and c. Those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture. A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments: a. Any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and b. Its share of the capital commitments of the joint ventures themselves. A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)*

Mr. A, Mr. B and Mr. C entered into a joint venture to purchase a land, construct and sell flats. Mr. A purchased a land for ₹ 60,00,000 on 01.01.2021 and for the purpose he took loan from a bank for ₹ 50,00,000 @ 8% interest p.a. He also paid registering fees ₹ 60,000 on the same day. Mr. B supplied the materials for ₹ 4,50,000 from his godown and further he purchased the materials for ₹ 5,00,000 for the joint venture.

Mr. C met all other expenses of advertising, labour and other incidental expenses which turnout to be ₹ 9,00,000.

On 30.06.2021 each of the venturer agreed to take away one flat each to be valued at ₹ 10,00,000 each flat and rest were sold by them as follow: Mr. A for ₹ 40,00,000; Mr. B for ₹ 20,00,000 and Mr. C for ₹ 10,00,000. Loan was repaid on the same day by Mr. A along with the interest and net proceeds were shared by the partners equally.

You are required to prepare the draft Consolidated Profit & Loss Account and Joint Venture Account in the books of each venturer.

Question 2 *(ICAI Study Material)*

A Ltd., B Ltd. and C Ltd. decided to jointly construct a pipeline to transport the gasfrom one place to another that was manufactured by them. For the purpose following expenditure was incurred by them: Buildings ₹ 12,00,000 to be depreciated @ 5% p.a., Pipeline for ₹ 60,00,000 to be depreciated @ 15% p.a., computers and other electronics for ₹ 3,00,000 to be depreciated @ 40% p.a. and various vehicles of ₹ 9,00,000 to be depreciated @ 20% p.a. They also decided to equally bear the total expenditure incurred on the maintenance of the pipeline that comes to ₹ 6,00,000 each year.

You are required to show the consolidated balance sheet and the extract of Statement of Profit & Loss and Balance Sheet for each venturer.

Solution

Consolidated Balance Sheet

		Note	(₹)
I	**Equity and liabilities**		
	Shareholders' funds:		
	Share Capital	1	71,40,000
			71,40,000
II	**Assets**		
	Non-current Assets		
	Property, Plant and Equipment:	2	71,40,000
			71,40,000

Notes to Accounts

			(₹)
1.	Share capital		
	A Ltd.	23,80,000	
	B Ltd.	23,80,000	
	C Ltd.	23,80,000	71,40,000
2.	Property, Plant and Equipment Land & Building:		
	A Ltd.	3,80,000	
	B Ltd.	3,80,000	
	C Ltd.	3,80,000	11,40,000

	Plant & Machinery:		
	A Ltd.	17,00,000	
	B Ltd.	17,00,000	
	C Ltd.	17,00,000	51,00,000
	Computers:		
	A Ltd.	60,000	
	B Ltd.	60,000	
	C Ltd.	60,000	1,80,000
	Vehicles:		
	A Ltd.	2,40,000	
	B Ltd.	2,40,000	
	C Ltd.	2,40,000	7,20,000

In the Books of A Ltd.
Extract of statement of Profit & Loss

Particulars	Note No.	₹
Depreciation and amortisation expense	1	4,20,000
Other operating Expenses (Pipeline Expenses)		2,00,000

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Property, Plant and Equipment	2	23,80,000

Notes to Accounts

		₹	₹
1.	Depreciation and amortisation expense		
	Land & Building	20,000	
	Plant & Machinery	3,00,000	
	Computers	40,000	
	Vehicles	60,000	4,20,000
2.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

In the Books of B Ltd. & C Ltd.: Same Presentation as in case of A Ltd.

Question 3 *(ICAI Study Material)*

A Ltd. a UK based company entered into a joint venture with B Ltd. in India, wherein B Ltd. will import the goods manufactured by A Ltd. on account of joint venture and sell them in India. A Ltd. and B Ltd. agreed to share the expenses & revenues in the ratio of 5:4 respectively whereas profits are distributed equally. A Ltd. invested 49% of total capital but has equal share in all the assets and is equally liable for all the liabilities of the joint venture. Following is the trial balance of the joint venture at the end of the first year:

Particulars	Dr. (₹)	Cr. (₹)
Purchases	9,00,000	
Other Expenses	3,06,000	
Sales		13,05,000
Property, Plant and Equipment	6,00,000	
Current Assets	2,00,000	
Unsecured Loans		2,00,000
Current Liabilities		1,00,000
Capital		4,01,000

Closing inventory was valued at ₹ 1,00,000.
You are required to prepare the Consolidated Financial Statement.

Solution

Consolidated Profit & Loss Account

Particulars	Note No.	(₹)
Revenue from operations	1	13,05,000
Total Revenue (A)		13,05,000
Less: Expenses		
Purchases	2	9,00,000
Other expenses	3	3,06,000
Changes in inventories of finished goods	4	(1,00,000)
Total Expenses (B)		11,06,000
Profit Before Tax (A-B)		1,99,000

Consolidated Balance Sheet

		Note No.	(₹)
I	**Equity and liabilities**		
	1. Shareholders' funds:		
	Share Capital	5	4,01,000
	Reserves and Surplus	6	1,99,000
	2. Non-current liabilities		
	Long term borrowings	7	2,00,000
	3. Current Liabilities	8	1,00,000
			9,00,000
II	**Assets**		
	Non-current Assets		
	Property, Plant and Equipment	9	6,00,000
	Current Assets		
	Inventories	10	1,00,000
	Other current assets	11	2,00,000
			9,00,000

Notes to Accounts

	Particulars		(₹)
1.	**Revenue from operations**		
	Sales: A Ltd.	7,25,000	
	B Ltd.	5,80,000	13,05,000
2.	**Purchases:**		
	A Ltd.	5,00,000	
	B Ltd.	4,00,000	9,00,000

3.	**Other Expenses:**		
	A Ltd.	1,70,000	
	B Ltd.	1,36,000	3,06,000
4.	**Closing Inventory:**		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
5.	**Share Capital:**		
	A Ltd.	1,96,490	
	B Ltd.	2,04,510	4,01,000
6.	**Reserve & Surplus:**		
	Profit & Loss Account A Ltd.	99,500	
	B Ltd.	99,500	1,99,000
7.	**Long term Borrowing:**		
	Unsecured Loans A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000
8.	**Current Liabilities:**		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
9.	**Property, Plant & Equipment:**		
	A Ltd.	3,00,000	
	B Ltd.	3,00,000	6,00,000
10.	**Inventories:**		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
11.	**Other Current Assets:**		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000

Question 4 *(ICAI Study Material)*

A Ltd. entered into a joint venture with B Ltd. on 1:1 basis and a new company C Ltd. was formed for the same purpose and following is the balance sheet of all thethree companies:

Particulars	A Ltd.	B Ltd.	C Ltd.
Share Capital	10,00,000	7,50,000	5,00,000
Reserve & Surplus	18,00,000	16,00,000	12,00,000
Loans	3,00,000	4,00,000	2,00,000
Current Liabilities	4,00,000	2,50,000	1,00,000
Property, Plant and Equipment	30,50,000	26,25,000	19,50,000
Investment in JV	2,50,000	2,50,000	-
Current Assets	2,00,000	1,25,000	50,000

Prepare the balance sheet of A Ltd. and B Ltd. under proportionate consolidationmethod.

Question 5

A Ltd. acquired shares in B Ltd. & C Ltd. on 1st April, 2022. Reserves and Surplus of B Ltd & C Ltd on date of acquisition are ₹ 10,00,000 and ₹ 9,50,000 respectively.

A Ltd. entered into a joint venture with X Ltd. on 1:1 basis and a new company D Ltd. was formed for the same purpose.

The Balance sheet of all companies as on 31st March, 2023 were as follows:

Particulars	A Ltd.	B Ltd.	C Ltd.	D Ltd.
Share Capital (₹ 10 each)	20,00,000	10,00,000	5,00,000	5,00,000
Reserve & Surplus	8,00,000	16,00,000	12,00,000	10,00,000
Loans	3,00,000	4,00,000	2,00,000	4,50,000
Current Liabilities	4,00,000	2,50,000	1,00,000	50,000
	35,00,000	**32,50,000**	**20,00,000**	**20,00,000**
Property, Plant & Equipment	5,50,000	26,25,000	19,50,000	15,00,000
Investments				
Inv. in 80,000 shares of B Ltd.	18,00,000			
Inv. in 20,000 shares of C Ltd.	7,00,000			
Inv. in Joint venture	2,50,000			
Current Assets	2,00,000	6,25,000	50,000	5,00,000
	35,00,000	**32,50,000**	**20,00,000**	**20,00,000**

Prepare consolidated balance sheet of A Ltd.

Question 6 *(ICAI Study Material)*

JVR Limited has made investments of ₹ 97.84 crores in equity shares of QSR Limited in pursuance of Joint Venture agreement till 2021-22 (i.e., morethan 12 months). The investment has been made at par. QSR Limited hasbeen in continuous losses for the last 2 years. JVR Limited is willing to reassess the carrying amount of its investment in QSR Limited and wish to provide for diminution in value of investments. However, QSR Limited has a futuristic and profitable business plans and projection for the coming years.
Discuss whether the contention of JVR Limited to bring down the carrying amount of investment in QSR Limited is in accordance with the Accounting Standard.

Solution

As per para 26 of AS 27 "Financial Reporting of Interests in Joint Ventures",in a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with AS 13 'Accounting for Investments'.

As per para 17 of AS 13 "Accounting for 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. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. Thetype and extent of the investor's stake in the investee are also taken into account. However, where there is a decline, other than temporary, in the carrying amounts of long-term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement.

Since the investment was made in the year 2021-2022 i.e., more than a year,it is a long-term investment. In the given case, though the QSR Ltd. is in continuous losses for past 2 years, yet it has a futuristic and profitable business plans and projections for the coming years. Here, one of the indicators i.e. 'losses incurred to the company' may lead to diminution inthe value of the shares while the other indicator that 'the company has positive expected cash flows from its business plans' does not lead to decline in the value of shares. Considering both the facts, in case the expectation of profitable businessplans and positive cash flows is based reliable presumptions (such as tenderin favour of QSR Ltd., strong order book etc.), the decline will be regardedas temporary in nature and the investment in equity shares will continue tobe carried at cost only.
However, should the aforesaid presumptions be based on projections without reasonable evidence backing the claims, the decline could be regarded as non-temporary in nature in which case the write down of the carrying amount become necessary in line with AS 13, thereby implying the contention of QSR Ltd. to be correct.

IMPAIRMENT OF ASSETS

AS 28

Coverage	This standard prescribes the procedures to be applied to ensure that the assets of enterprise are carried at amount not exceeding their recoverable amount (amount to be recovered through use or sale of the asset). The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets.	
Scope	The standard should be applied in accounting for impairment of all assets ***except*** 1. inventories (AS 2), 2. assets arising under construction contracts (AS 7), 3. financial assets including investments covered under AS 13, and 4. deferred tax assets (AS 22). There are chances that the provision on account of impairment losses may increase sickness of companies and potentially sick companies may actually become sick.	
Definitions	**Impairment Loss**	It is the amount by which the carrying amount of an asset exceeds its recoverable amount.
	Recoverable Amount	It is the higher of an asset's net selling price and it's value in use.
	Net Selling Price	It is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
	Costs of Disposal	These are incremental costs directly attributable to the disposal of an asset, ***excluding*** finance costs and income tax expense
	Value in Use	It 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
	Carrying Amount	It is the amount at which an asset is recognised in balance sheet after deducting any accumulated depreciation (amortization) and accumulated impairment losses thereon.
Assessment	An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications: **External sources of information** ❖ During period, an asset's market value has declined significantly more than would be expected as result of the passage of time or normal use. ❖ Significant changes with an adverse effect on the enterprise have taken place during the period, or will take place soon, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated.	

	❖ 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. ❖ The carrying amount of the net assets of the reporting enterprise is more than its market capitalization. **Internal sources of information** ❖ Evidence is available of obsolescence or physical damage of an asset. ❖ 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 ❖ Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected. An enterprise may identify other indications that an asset may be impaired, and these would also require the enterprise to determine the asset's recoverable amount. **Example** that indicates that an asset may be impaired because of the following: a) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted. b) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted. c) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or d) operating losses or net cash outflows for the asset when current period figures are aggregated with budgeted figures for the future. The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated.
Estimate of Cash Flows	Cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence. Cash flow projections should be based on the most recent approved budgets/forecasts for a maximum of 5 years. Financial budgets/forecasts over a period longer than 5 years may be used if management is confident that these projections are reliable and it can demonstrate its ability, based on experience, to forecast cash flows accurately over that longer period. *Estimates of future cash flows should include:* (i) Projections of net cash inflows from the continuing use of the asset (ii) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset and that can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and (iii) Net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life

	Care should be taken for the following points: a. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale should be included. b. Cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review should not be included. c. Cash outflows that relate to obligations that have already been recognised as liabilities to be excluded. d. Future cash outflows or inflows expected to arise because of restructuring of the organization should be not considered. e. Any future capital expenditure enhancing the capacity of the assets and its related savings/outflow should be excluded. f. Any increase in expected cash inflow from the above expenditure should also be excluded. g. Estimates of future cash flows should not include cash inflows or outflows from financing activities and also income tax receipts or payments. h. The estimate of net cashflow upon disposal of the asset should be the amount that an enterprise expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties prevailing at the date of the estimates, after deducting the estimated costs of disposal. **Foreign Currency Future Cash Flows** are estimated in currency in which it will be generated and then they are discounted for the time value of money using a discount rate appropriate for that currency we convert cashflow in the reporting currency on the basis of AS 11.
Discount Rate	The discount rate(s) should be a pre-tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. An enterprise normally uses a single discount rate for the estimate of an asset's value in use. However, an enterprise uses separate discount rates for different future periods where value in use is sensitive to a difference in risks for different periods or to the term structure of interest rates.

Recognition and Measurement of Impairment Loss

Case I:

If recoverable amount of assets more than carrying amount, we ignore the difference and asset is carried on at the same book value.

Note: If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation method or the residual value for the asset need to be reviewed and adjusted under the AS 10, even if no impairment loss is recognised for the asset

Case II:

When this recoverable amount is less than the carrying amount, this difference termed as Impairment Loss.

Treatment of Impairment loss: It should be written off immediately as expenses to P&L A/c. If assets are carried out at revalued figures then the impairment loss equivalent to revalued surplus is adjusted with it and the balance (if any) is charged to Profit & Loss Account.

Depreciation: Depreciation for the coming years on the assets are recalculated on the basis of the new carrying amount, residual value and remaining useful life of the asset, according to AS 10

Case III:

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 AS.

Identification of Cash Generating Unit (CGU)

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.

Recoverable Amount & Carrying Amount of a CGU

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 liability only if that liability is necessary to be considered to determine the recovery 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 cashgenerating 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.

Impairment Loss for a CGU

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.

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.

Case 1: If goodwill can be allocated on a reasonable and consistent basis: An enterprise applies the 'bottom-up' test only.
Case 2: 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

Example:
At the end of 2020, enterprise M acquired 100% of enterprise Z for ₹ 3,000 lakhs. Z has 3 cash-generating units A, B and C with net fair values of ₹ 1,200 lakhs, ₹ 800 lakhs and₹ 400 lakhs respectively. M recognises goodwill of ₹ 600 lakhs (₹ 3,000 lakhs less ₹ 2,400 lakhs) that relates to Z.
At the end of 2024, A makes significant losses. Its recoverable amount is estimated to be ₹ 1,350 lakhs. Carrying amounts are detailed below (₹ In Lakh).

End of 2024	A	B	C	Goodwill	Total
Net carrying amount	1300	1200	800	120	3420

Scenario A – Goodwill Can be Allocated on a Reasonable and Consistent Basis
On date of acquisition of Z, the net fair values of A, B and C are considered a reasonable basis for a pro-rata allocation of the goodwill to A, B and C.
Allocation of goodwill at the end of 2024:

	A	B	C	Goodwill
End of 2020				
Net fair values	1200	800	400	2400
Pro-Rata	50%	33%	17%	100%
End of 2024				
Net carrying amount	1300	1200	800	3300
Allocation of goodwill (Using pro rate above)	60	40	20	120
Net carrying amount (After goodwill)	1360	1240	820	3420

In accordance with the 'bottom-up' test as per AS 28, M compares A's recoverable amount to its carrying amount after the allocation of the carrying amount of goodwill:

End of 2024	A (₹ In Lakh)
Carrying amount after allocation of goodwill	1360
Recoverable amount	1350
Impairment loss	10

M recognises an impairment loss of ₹ 10 lakhs for A. The impairment loss is fully allocated to the goodwill in accordance with AS 28.

Scenario B – Goodwill Cannot be Allocated on a Reasonable and Consistent Basis
There is no reasonable way to allocate the goodwill that arose on the acquisition of Z to A, B and C. At the end of 2024, Z's recoverable amount is estimated to be ₹ 3,400 lakhs.
At the end of 2024, M first applies the 'bottom-up' test in accordance with AS 28. It compares A's recoverable amount to its carrying amount excluding the goodwill.

End of 2024	A (₹ In Lakh)
Carrying amount	1300
Recoverable amount	1350
Impairment loss	0

Therefore, no impairment loss is recognised for A as a result of the 'bottom-up' test.
Since the goodwill could not be allocated on a reasonable and consistent basis to A, M also performs a 'top-down' test in accordance with AS 28. It compares the carrying amount of Z as a whole to its recoverable amount (Z as a whole is the smallest cash-generating unit that includes A and to which goodwill can be allocated on reasonable and consistent basis).

Application of the 'top-down' test **(Amount in ₹ lakhs)**

End of 2024	A	B	C	Goodwill	Total
Carrying amount	1300	1200	800	120	3420
Impairment loss arising from 'bottom-up' test	0	-	-	-	0
Carrying amount after the 'bottom-up' Test	1300	1200	800	120	3420
Recoverable amount	-	-	-	-	3400
Impairment loss arising from 'top- down' test	-	-	-	-	20

Therefore, M recognises an impairment loss of ₹ 20 lakhs that it allocates fully to goodwill in accordance with AS 28.

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 for an Individual Asset

Case 1: 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 2: 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 amortization 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.

Reversal for a CGU

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, 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 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.

A) **If in entirety:** 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.
B) **If in other ways such as Piecemeal distribution**: Recoverable amount is determined for individual assets, unless the assets are sold in groups.
C) If the enterprise **abandons** the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

DISCLOSURE REQUIREMENTS

For each class of assets, the financial statements should disclose:

a. The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;
b. The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;
c. The amount of impairment losses recognised directly against revaluation surplus during the period; and
d. The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

a. The amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and
b. The amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

a. The events & circumstances that led to the recognition or reversal of impairment loss;
b. The amount of the impairment loss recognised or reversed;
c. For an individual asset:
   (i) The nature of the asset; and
   (ii) The reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);
d. For a cash-generating unit:
   (i) A description of the CGU (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);
   (ii) The amount of the impairment loss recognised or reversed by class of assets & by reportable segment based on enterprise's primary format (as defined in AS 17); and
   (iii) If the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;
e. Whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;
f. If recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and
g. If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

a. The main classes of assets affected by impairment losses (reversals of impairment losses);
b. The main events and circumstances that led to the recognition (reversal) of these impairment losses.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no.*_____

Ergo Industries Ltd. gives the following estimates of cash flows relating to Property, Plant and equipment on 31-12-2021. The discount rate is 15%.

Year	Cash Flow (₹ in lakhs)
2022	4000
2023	6000
2024	6000
2025	8000
2026	4000
Residual value at the end of 2026	₹ 1000 lakhs
Property, Plant and Equipment purchased on 1-1-2019	₹ 40,000 lakhs
Useful life	8 years
Net selling price on 31-12-2021	₹ 20,000 lakhs

Calculate on 31-12-2021:

(a) Carrying amount at the end of 2021
(b) Value in use on 31-12-2021
(c) Recoverable amount on 31-12-2021
(d) Impairment loss to be recognized for the year ended 31-12-2021
(e) Revised carrying amount
(f) Depreciation charge for 2022.

Question 2 *(ICAI Study Material)* *Pg no.*_____

X Ltd. is having a plant (asset) carrying amount of which is ₹ 100 lakhs on 31.3.2021. Its balance useful life is 5 years and residual value at the end of 5 yearsis ₹ 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)
31.3.2022	50
31.3.2023	30
31.3.2024	30
31.3.2025	20
31.3.2026	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 31.3.2021 is ₹ 60 lakhs.

Question 3 *(ICAI Study Material)* *Pg no.*_____

G Ltd., acquired a machine on 1st April, 2020 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, 2024, 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, 2026, 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 ofG Ltd. G Ltd., had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.

Question 4 *(ICAI Study Material)* *Pg no.*_____

An asset does not meet the requirements of environment laws which havebeen 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

Impairment loss = Carrying amount - Recoverable amount,
where recoverable amount is higher of an asset's net selling price* andits 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 impairmentloss 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 AS 28.
Further, as per 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.

*Net selling price = Selling price – Cost of disposal = Nil – ₹ 70,000 = (₹ 70,000)
**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. In the given case, value in use is nil.

Question 5 *(ICAI Study Material)* *Pg no.*_____

A plant was acquired 15 years ago at a cost of ₹ 5 crores. Its accumulated depreciation as at 31st March, 2021 was ₹ 4.15 crores. Depreciation estimated for the financial year 2021-2022 is ₹ 25 lakhs. Estimated Net Selling Price ason 31st March, 2021 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, 2021, whichis expected to decrease by 30 per cent by the end of the financial year.

a. 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, 2022?
b. How much will be the amount of write off for the financial year ended 31st March, 2022?
c. 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?
d. 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?

Question 6 *(ICAI Study Material)* *Pg no.*_____

X Ltd. purchased a Property, Plant and Equipment four years ago for ₹ 150 lakhsand 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 willbe 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

Treatment of Impairment Loss

As per AS 28 "Impairment of assets", if the recoverable amount (higherof 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 revaluationof 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 4years]	(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

Question 7 *(ICAI Study Material)* *Pg no._____*

Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 2021 for ₹ 60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 2021-2022 the carrying amountwas ₹ 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, ifsold 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

As per provisions of AS 28, 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 8 *(ICAI Study Material) / (RTP Sep 2024)* *Pg no._____*

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 inflowsfrom 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 immediatelywith new titles for the same customer segment. What is the cash-generating unit for an individual magazine title?

Solution

It is likely that the recoverable amount of an individual magazine title canbe 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, decisionsto abandon titles are made on an individual title basis.

Therefore, it is likely that individual magazine titles generate cash inflowsthat are largely independent of each other and that each magazine title is a separate cash-generating unit.

Question 9

*Pg no.*_____

A mining entity owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine.

Recommend whether the entity should determine the recoverable amount for the private railway or for the mining business as a whole.

Solution

It is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, i.e., the mine as a whole.

Question 10

*Pg no.*_____

A bus company provides services under contract with a municipality that requires minimum service on each of seven 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. Examine whether the company should determine the recoverable amount for an individual asset or for a cash generating unit.

Solution

Because the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the seven routes together. The cash-generating unit for each route is the bus company as a whole.

Question 11

*Pg no.*_____

A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is ₹ 500, which is equal to the present value of the restoration costs.

The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around ₹ 800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately ₹ 1,200, excluding restoration costs. The carrying amount of the mine is ₹ 1,000. Recommend the impairment loss is to be accounted for.

Solution

The cash-generating unit's fair value less costs of disposal is ₹ 800. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be ₹ 700 (₹ 1,200 less ₹ 500). The carrying amount of the cash-generating unit is ₹ 500, which is the carrying amount of the mine (₹ 1,000) less the carrying amount of the provision for restoration costs (₹ 500). Therefore, the recoverable amount of the cash generating unit exceeds its carrying amount. Thus, there is no impairment loss.

Question 12

Pg no._____

A Ltd. purchased an asset of ₹ 100 lakh on 1st April, 2020. It has useful life of 4 years with no residual value. Recoverable amount of the asset is as follows:

As on	Recoverable amount
31st March, 2021	₹ 60 lakh
31st March, 2022	₹ 40 lakh
31st March, 2023	₹ 28 lakh

Calculate the amount of impairment loss or its reversal, if any, on 31st March, 2021, 31st March, 2022 and 31st March, 2023.

Solution

As on 31st March, 2021

Carrying amount of the asset (opening balance)	₹ 100 Lakhs
Depreciation (₹ 100 lakh /4 years)	₹ 25 Lakhs
Carrying amount of the asset (closing balance)	**₹ 75 Lakhs**
Recoverable amount (given)	₹ 60 Lakhs

Therefore, an impairment loss of ₹ 15 lakh should be recognised as on 31st March, 2021.
Depreciation for subsequent years should be charged on the carrying amount of the asset (after providing for impairment loss), i.e., ₹ 60 lakh.

As on 31st March, 2022

Carrying amount of the asset (opening balance)	₹ 60 Lakhs
Depreciation (₹ 60 lakh /3 years)	₹ 20 Lakhs
Carrying amount of the asset (closing balance)	**₹ 40 Lakhs**

Therefore, no impairment loss should be recognised as on 31st March, 2022.

As on 31st March, 2023

Carrying amount of the asset (opening balance)	₹ 40 Lakhs
Depreciation (₹ 40 lakh /2 years)	₹ 20 Lakhs
Carrying amount of the asset (closing balance)	**₹ 20 Lakhs**
Recoverable amount (given)	₹ 28 Lakhs

Since, the recoverable amount of the asset exceeds the carrying amount of the asset by ₹ 8 lakh, impairment loss recognised earlier should be reversed. However, 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 years.
Carrying amount as on 31st March, 2023 had no impairment loss being recognised would have been ₹ 25 lakh. Therefore, the reversal of an impairment loss of ₹ 5 lakh should be done as on 31st March, 2023.

PRACTICE QUESTIONS

Question 1 *(ICAI Study Material)* *Pg no._____*

Write short note on impairment of asset and its application to inventory.

Solution

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.

a. If carrying amount < = Recoverable amount: Asset is not impaired
b. 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.

Question 2 *(ICAI Study Material)* *Pg no._____*

Venus Ltd. has a fixed asset, which is carried in the Balance Sheet on 31.3.2021 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:

a. Calculate impairment loss.
b. Prepare journal entries for adjustment of impairment loss.
c. Show, how impairment loss will be shown in the Balance Sheet.

Solution

a. Recoverable amount is higher of value in use 400 lakhs & net selling price 375 lakhs
Recoverable amount = ₹400 lakhs
Impairment loss = Carrying Amount – Recoverable amount =
₹500 lakhs – ₹400 lakhs = ₹100 lakhs.

b. Journal Entries **(₹ in lakhs)**

	Particulars	Dr.	Cr.
(i)	Impairment Loss A/c Dr.	100	
	To Provision for Accumulated Impairment Loss A/c		100
	(Being the entry for accounting impairment loss)		
(ii)	Profit and loss A/c Dr.	100	
	To Impairment Loss A/c		100
	(Being the entry to transfer impairment loss to P&L A/c)		

c. Balance Sheet of Venus Ltd. as on 31.3.2021

	(₹ in lakhs)
Fixed Asset	
Asset less depreciation	500
Less: Impairment loss	(100)
	400

Question 3 *(ICAI Study Material)* *Pg no._____*

From the following details of an asset

a. Find out impairment loss
b. Treatment of impairment loss
c. 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

According to AS 28 "Impairment of Assets", an impairment loss on a revalued asset is recognised as an expense in the statement of profit andloss. 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 theasset'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.

PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

AS 29

AS-29 prescribes the guidance in respect of recognition, measurement and disclosures of provisions, contingent liabilities and contingent assets. The standard clearly defines the role of management while making an estimate for creating provisions and the auditors to vouch for the correctness or otherwise of the estimate made by the management. This ensures that manipulations do not take place at the time of creation of provisions.

Where another Accounting Standard such as AS 7; AS 9; AS 15; AS 19 and AS 22 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of AS 29.

Liabilities	It 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.
Present Obligation	An obligation is a present obligation if based on the evidence available, its existence at the balance sheet date is considered probable i.e. more likely than not (>50%).
Possible Obligation	An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet is considered not probable (< 50%).
PROVISION	
Meaning	A Provision is a liability which can be measured only by using a substantial degree of estimation.
Recognition criteria (PARA 14)	A provision should be recognized when: → An enterprise has a present obligation as a result of past event. → It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. → And a reliable estimate can be made of the amount of obligation. If these conditions are not met, no provision should be recognized. ***Example***: X Ltd. sells refrigerators with a warranty of 6 months. The refrigerators would be repaired free of cost by X Ltd. if some problem arises during the next 6 months of sale. There is a present obligation for X Ltd because if some defect arises, X Ltd would need to incur expenses on repairs of the refrigerator. Thus, a provision is required to be made in the books of X Ltd.
Measurement of provisions	Amount recognized as provision should be the best estimate of expenditure required to settle the present obligation at the balance sheet date.
Determinants of best estimate (Illustrative)	❖ Judgement of the management of the enterprise. ❖ Experience of similar transactions ❖ Reports from independent experts ❖ Any additional evidence provided by events after the balance sheet date.
Notes	❖ Provision should not be recognized for future operating losses. ❖ Provision should be measured before tax ❖ Provision should not be discounted to its present value.

	Exception: Discounting of provision for decommissioning, restoration and similar liabilities should be done as per the pre-tax discount rate as mentioned therein. ***Example:*** Z Ltd takes a building on lease for 10 years. The terms of the contract provide that Z Ltd must vacate the building in its original condition. Z Ltd expects that there is a likely cost of 10 lakhs to be spent at the end of 10 years for restoration. Since there is a present obligation on X Ltd at the time of entering into the lease contract, provision to the extent of present value of this amount should be created ❖ Provision should be reviewed at each balance sheet date ❖ It should be adjusted to reflect the current best estimate ❖ If it is no longer probable that there will be outflow of resources, then provision should be reversed.
CONTINGENT LIABILITY	
Meaning	It is: → A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the enterprise ***OR*** → A present obligation that arises from past events but is not recognized because ➢ it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation **OR** ➢ A reliable estimate of the amount of the obligation cannot be made.

	Elements	Cases				
1.	Possible obligation	X	X	X	X	√
2.	Present obligation from past events	√	√	√	√	NA
3.	Expected outflow	√	√	X	X	NA
4.	Measurability (using substantial degree of estimation)	√	X	√	X	NA
5.	Whether it is Provision(P) or Contingent liability (CL)	P	CL	CL	CL	CL

Recognition	Contingent liability should not be recognized
Disclosure	Contingent liability should be disclosed **Exception:** The possibility of an outflow of resources embodying economic benefits is remote (i.e. no disclosure is even required in such case).
CONTINGENT ASSETS	
Meaning	It is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of an enterprise.

Recognition	A contingent asset should not be recognized. **Note:** When the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
Disclosure	❖ Contingent asset should not be disclosed in the financial statements ❖ It is disclosed in the director's report.
REIMBURSEMENT	
Meaning	When some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (example through insurance contracts, indemnity clauses, supplier's warranty etc.), reimbursement should be recognized when and only when it is virtually certain that reimbursement will be received if the enterprise settles the obligation.
Valuation & Disclosure	❖ Reimbursement recognized should not exceed the amount of provision. ❖ In Balance Sheet, reimbursement should be presented as a separate asset. ❖ In the Statement of P&L, provision may be presented net of the amount recognized for reimbursement.
RESTRUCTURING	
Meaning	A restructuring is a programme that is planned and controlled by management, and materially changes either: (a) the scope of a business undertaken by an enterprise; or (b) the manner in which that business is conducted
Examples	❖ sale or termination of a line of business; ❖ the closure of business locations in a country or region or the relocation of business activities from one country or region to another; ❖ changes in management structure, for example, eliminating a layer of management; and ❖ fundamental re-organizations that have a material effect on the nature and focus of the enterprise's operations.
Whether provision required?	➢ A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in Para 14 are met. ➢ No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.
Inclusions & Exclusions	A restructuring provision should include only the direct expenditures arising from the restructuring which are those that are both: (a) necessarily entailed by the restructuring; and (b) not associated with the ongoing activities of the enterprise. A restructuring provision does not include such costs as: (a) retraining or relocating continuing staff; (b) marketing; or (c) investment in new systems and distribution networks.

ONEROUS CONTRACT	
Meaning	It is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the ***lower*** of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.
Example	An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2020 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user. **Present obligation as a result of a past obligating event-** The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation. **An outflow of resources embodying economic benefits in settlement-** When the lease becomes onerous, an outflow of resources embodying economic benefits is probable ***Conclusion***-A provision is recognised for the best estimate of the unavoidable lease payments.

ASSIGNMENT QUESTIONS

Question 1 *(ICAI Study Material)*

At the end of the financial year ending on 31st December, 2020, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by Board of Directors. The possible outcome as estimated by Board is as follows:

	Probability	Loss (₹)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Loss (Low damages)	40%	1,20,000
Loss (High damages)	10%	2,00,000
Remaining five cases		
Win	50%	-
Loss (Low damages)	30%	1,00,000
Loss (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

An engineering goods company provides after sales warranty for 2 years to its customers. Based on past experience, the company has been following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period:

Less than 1 year : 2% provision

More than 1 year : 3% provision

The company has raised invoices as under:

Invoice Date	Amount (₹)
19th January, 2018	40,000
29th January, 2019	25,000
15th October, 2019	90,000

Calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2019 and 31st March, 2020. Also compute amount to be debited to Profit and Loss Account for the year ended 31st March, 2020

Question 3 *(Inter Jan 2025) (7 Marks)*

An Engineering goods company provides 'after sales warranty' for 2 years to its customers. Based on the past experience, the company has been following policy for making provision for warranties on the Invoice amount on the remaining balance warranty period:

Invoice less than 1 year : 2.5% provision

Invoice more than 1 year : 4.5% provision

The Company has raised Invoices as under:

Invoice Date	₹
20th February, 2021	42,000
17th July, 2021	25,000
27th January, 2022	47,000
1st March, 2023	1,10,000
24th August, 2023	34,000
20th March, 2024	75,000

You are required to:

a) Calculate the provision to be made for warranty under AS 29 as at 31st March, 2023 and 31st March, 2024:

b) Also compute the amount to be debited to Profit and Loss Account for the year ended 31st March, 2024.

Question 4 *(RTP Nov 2018 & May 2019) (Similar)*

WZW Ltd. is in a dispute involving allegation of infringement of patents by a competitor company who is seeking damages of a huge sum of ₹ 1,000 lakhs. The directors are of the opinion that the claim can be successfully resisted by the company. How would you deal the same in the annual accounts of the company?

Solution

As per para 14 of AS 29, a provision should be recognized when

a) an enterprise has a present obligation as a result of a past event;

b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognized.

A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. The possibility of an outflow of resources embodying economic benefits seems to be remote in the given situation, since the directors of WZW Ltd. are of the opinion that the claim can be successfully resisted by the company.

Therefore, the company shall not disclose the same as contingent liability. However, following note in this regard may be given in annual accounts of the company:

"Litigation is in process against the company relating to a dispute with competitor who alleges that the company has infringed patents and is seeking damages of ₹ 1,000 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company".

Question 5 *(ICAI Study Material / (RTP May 2021) (Similar)*

EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2020. The company seeks your advice on the following:

a) The Company's sales tax assessment for assessment year 2017-18 has been completed on 14th February, 2020 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

b) The company has entered into a wage agreement in May 2020 whereby the labour union has accepted a revision in wage from June 2019. The agreement provides that the hike till May 2020 will not be paid to employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September 2020.

Solution

a) Since the company is not appealing against the addition of ₹ 0.66 crore (₹ 2.76 crore less ₹ 2.10 crore), therefore, the same should be provided/ expensed off in its accounts for the year ended on 31st March, 2020. However, the amount paid under protest can be kept under the heading 'Long-term Loans & Advances / Short-term Loans and Advances' as the case may be along with disclosure as contingent liability of ₹ 2.10 crore.

b) The arrears for the period from June, 2019 to March, 2020 are required to be provided for in the accounts of the company for the year ended on 31st March, 2020 assuming that negotiations for hike in wages had already started in the year 2019-20 i.e. before the balance sheet date though the agreement was entered in May, 2020.

Question 6 *(RTP Nov 2021) / (ICAI Study Material)*

An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31st March 2020, it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary?

Solution

As per AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a past event will lead to present obligation when the enterprise has no realistic alternative to settle the obligation created by past event.

However, when environmental damage is caused, there may be no obligation to remedy the consequences. The causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalized, an obligation arises only when the legislation is virtually certain to be enacted.

In the given case it is virtually certain that law will be enacted requiring clean-up of a land already contaminated. Therefore, an oil company has to provide for such clean-up cost in the year in which the law is virtually certain to be enacted.

Question 7 *(RTP May 2020)*

With reference to AS-29, how would you deal with the following in the annual accounts of the company at the Balance Sheet dates:

(i) An organization operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten percent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

(ii) During 2018-19 Ace Ltd. gives a guarantee of certain borrowings of Brew Ltd., whose financial condition at that time is sound. During 2019-20, the financial condition of Brew Ltd. deteriorates and at 31st Dec. 2019 it goes into Liquidation.
State whether a provision is required: (a) At 31 March 2019 (b) At 31 March 2020

Solution

(i) The construction of the oil rig creates an obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil. An outflow of resources embodying economic benefits in settlement is probable. Thus, a provision is recognized for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig.
However, there is no obligation to rectify the damage that will be caused by extraction of oil, as no oil has been extracted at the balance sheet date. So, no provision is required for the cost of extraction of oil at balance sheet date.
Ten per cent of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

(ii)

(a) At 31 March 2019

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2019.

Conclusion – No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 2020

Present obligation as a result of a past obligating event – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – At 31 March 2020, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion – A provision is recognised for the best estimate of the obligation.

Question 8

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2020. The enterprise has not fitted the smoke filters.

State whether a provision is required:-

(a) At the balance sheet date of 31 March 2020

(b) At the balance sheet date of 31 March 2021

Solution

(a) At 31 March 2020

Present obligation as a result of past obligating event-There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion – No provision is recognised for the cost of fitting the smoke filters.

(a) At 31 March 2021

Present obligation as a result of a past obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed

Question 9 *(RTP Nov 2021) / (RTP Sep 2024)*

A company incorporated under Section 8 of the Companies Act having main objectives to promote the trade by organizing trade fairs/exhibitions. When the company was organizing the trade fair and exhibitions it decided to charge 5% contingency charges for the participants/outside agencies on the income received from them by the company, while in the case of fairs organized by outside agencies, 5% contingency charges are levied separately in the invoice, the contingency charges in respect of fairs organized by the company itself are inbuilt in the space rent charged from the participants. Both are credited to income & expenditure account of the company.

The intention of levying these charges is to meet any unforeseen liability, which may arise in future. The instances of such unforeseen liabilities could be on account of injury/loss of life to visitors/exhibitors etc. due to fire, terrorist attack, stampede, natural calamities and other public and third party liability. The chances of occurrence of these events are high because of large crowds visit the fair. The decision to levy 5% contingency charges was based on assessment only as actual liability on this account cannot be estimated.

The following accounting treatment and disclosure was made by the company in its financial statements:

1) 5% contingency charges are treated as income and matching provision for the same is also being made in accounts.
2) A suitable disclosure to this effect is also made in the notes forming part of accounts.

Required:

(i) Whether creation of provision for contingencies under the facts and circumstances of the case is in conformity with AS 29.

(ii) If the answer of (i) is "No" then what should be the treatment of the provision which is already created in the balance sheet.

Solution

(i) As per paragraph 14 of AS 29, a provision should be recognised when:

a. an enterprise has a present obligation as a result of a past event
b. it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and
c. a reliable estimate can be made of the amount of obligation.

If these conditions are not met, no provisions should be recognised.

From the above, it is clear that for the contingencies considered by the company, neither a present obligation exists because of past event, nor a reliable estimate can be made of the amount of the obligation. Accordingly, a provision cannot be recognized for such contingencies under the facts and circumstances of the case.

(ii) "Provision" is the amount retained by the way of providing for any known liability. Since the contingencies stipulated by the company are not known at the balance sheet date, the provision in this regard cannot be created. Therefore, the provision so created by the company shall be treated as a 'Reserve'.

Question 10

CASE 1 Court Case

After a wedding in 2019-20, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2020, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2021, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2020

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised.

The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 2021

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation.

CASE 2 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation.
An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole
Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date.

CASE 3 Refund Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.
An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund
Conclusion - A provision is recognised for the best estimate of the costs of refunds

CASE 4 Staff Retraining

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.
Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.
Conclusion - No provision is recognized

CASE 5 Refurbishment Costs - No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.
Conclusion - No provision is recognized.
The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

CASE 6 Refurbishment Costs – Legislative Requirement

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.
Conclusion - No provision is recognised.

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in above question. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

However, an obligation might arise to pay fines or penalties under the legislation after completion of three years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than three years.

Question 11 *(ICAI Study Material)*

Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 2019-20 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2020-21 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2019-20 financial year. As on balance sheet date (31.3.2020), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.

(i) Should Sun Ltd. provide for contingency as per AS 29?

(ii) Should provision be measured as the excess of compensation to be paid over the profit?

Solution

(i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting ₹ 1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2020 and no profit had accrued for the financial year 2019-2020. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.5 crores.

Question 12 *(RTP May 2018) / (RTP Nov 2019)*

The company has not made provision for warrantee in respect of certain goods considering that the company can claim the warranty cost from the original supplier. Hence the accountant of the company says that the company is not having any liability for warrantees on a particular date as the amount gets reimbursed. You are required to comment on the accounting treatment done by the XYZ Ltd. in line with the provisions of AS 29. Comment

Solution

As per AS 29, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

It is apparent from the question that the company had not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from

the original supplier. However, the provision for warranty should have been made as per AS 29 and the amount claimable as reimbursement should be treated as a separate asset in the financial statements of the company rather
than omitting the disclosure of such liability. Accordingly, it was viewed that the accounting treatment adopted by the company with respect to warranty is not correct.

Question 13

M/s. Shishir Ltd., a public Sector Company, provides consultancy and engineering services to its clients. In the year 2019-20, the Government set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2017 based on the recommendations of the commission. The company makes the provision of ₹ 1250 lakhs for pay revision in the financial year 2019-20 on the estimated basis as the report of the commission is yet to come. As per the contracts with 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 & benefits include the provision of ₹ 1250 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/recognize the income by ₹ 1250 lakhs in Profit & Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit. Comment on his opinion with reference to relevant AS.

Solution

As per AS 29, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision. 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 ₹ 1,250 lakhs will be ultimately collected from the client, as per the terms of the contract. Therefore, the liability of ₹ 1,250 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 ₹ 1,250 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 ₹ 1,250 lakhs is not as per AS-29 and also the concept of prudence will not be followed if ₹ 1,250 lakhs is simultaneously recognized as income. ₹ 1,250 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 ₹ 1,250 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.

Question 14

Mini Ltd. took a factory premises on lease on 1.4.2019 for ₹ 2,00,000 per month. The lease is operating lease. During March, 2020, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2022.The lease cannot be

cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2022 should be provided in the accounts for the year ending 31.3.2020. Mini Ltd. seeks your advice

Solution

In accordance with AS 29 'Provisions, Contingent Liabilities and Contingent Assets', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous as the economic benefit of lease contract for next 33 months up to 31.12.2022 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of ₹ 66,00,000 (i.e.2,00,000 p.m. for next 33 months).

Therefore, provision on account of ₹ 66,00,000 is to be provided in the accounts for the year ending 31.03.2020. Hence auditor is right.

Question 15 *(RTP Jan 2025)*

During the year, QA Ltd. delivered manufactured products to customer K. The products were faulty and on 1st October, 2023 customer K commenced legal action against the Company claiming damages in respect of losses due to the supply of faulty product. Upon investigating the matter, QA Ltd. discovered that the products were faulty due to defective raw material procured from supplier F. Therefore, on 1st December, 2023, the Company commenced legal action against F claiming damages in respect of the supply of defective raw materials.

QA Ltd. has estimated that it's probability of success of both legal actions, the action of K against QA Ltd. and action of QA Ltd. against F, is very high.

On 1st October, 2023, QA Ltd. has estimated that the damages it would have to pay K would be ₹ 5 crore. This estimate was revised to ₹ 5.2 crore as on 31st March, 2024 and ₹ 5.25 crore as at 15th May, 2024. This case was eventually settled on 1st June, 2022, when the Company paid damages of ₹ 5.3 crore to K.

On 1st December, 2023, QA Ltd. had estimated that it would receive damages of ₹ 3.5 crore from F. This estimate was revised to ₹ 3.6 crore as at 31st March, 2024 and ₹ 3.7 crore as on 15th May, 2024. This case was eventually settled on 1st June, 2022 when F paid ₹ 3.75 crore to QA Ltd. QA Ltd. had, in its financial statements for the year ended 31st March, 2024, provided ₹ 3.6 crore as the financial statements were approved by the Board of Directors on 26th April, 2024.

a) Whether the Company is required to make provision for the claim from customer K as per applicable AS? If yes, please give the rationale for the same.
b) If the answer to (a) above is yes, what is the entry to be passed in the books of account as on 31st March, 2024?
c) What will the accounting treatment of the action of QA Ltd. against supplier F as per applicable AS?

Solution

a) Yes, QA Ltd. is required to make provision for the claim from customer K as per AS 29 since the claim is a present obligation as a result of delivery of faulty goods manufactured. Also, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations. Further, a reliable estimate of ₹ 5.2 crore can be made of the amount of obligation while preparing financial statements as on 31st March, 2024.

b)

Statement of Profit and Loss A/c	Dr.	₹ 5.2 crore	
To Current Liability A/c			₹ 5.2 crore

c) As per AS 29, QA Ltd. shall not recognise a contingent asset. Here the probability of success of legal action is very high but there is no concrete evidence which makes the inflow virtually certain. Hence, it will be considered as contingent asset only and shall not be recognized.

PRACTICE QUESTIONS

Question 1 *(Inter Nov 2022) (5 Marks)*

At the end of the financial year ending on 31st March, 2022, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

Particulars	Probability	Loss (₹)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Lose (Low damages)	40%	12,00,000
Lose (High damages)	10%	20,00,000
Remaining five cases (Win)	50%	-
Lose (Low damages)	30%	10,00,000
Lose (High damages)	20%	21,00,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof as per AS - 29.

Solution

According to AS 29 (Revised) 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

a) There is a present obligation arising out of past events but not recognized as provision.
b) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
c) The possibility of an outflow of resources embodying economic benefits is not remote.
d) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 50% and for remaining five cases is 50%. As per AS 29 (Revised), we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 40% of ₹ 12,00,000 + 10% of ₹ 20,00,000
= ₹ 4,80,000 + ₹ 2,00,000
= ₹ 6,80,000

Expected loss in remaining five cases = 30% of ₹ 10,00,000 + 20% of ₹ 21,00,000
= ₹ 3,00,000 + ₹ 4,20,000
= ₹ 7,20,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of 1,04,00,000 (₹ 6,80,000 x 10 + ₹ 7,20,000 x 5) as contingent liability.

Question 2 *(Inter Nov 2019) (5 Marks) / (RTP May 2023) / (ICAI Study Material)*

A Ltd. provides after sales warranty for two years to its customers. Based on past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period.

Less than 1 year: 2% provision More than 1 year: 3% provision

The company has raised invoices as under:

Invoice Date	Amount (₹)
11th February, 2018	60,000
25th December, 2018	40,000
4th October, 2019	1,35,000

Calculate the provision to be made for warranty under AS-29 as at 31st March, 2019 and 31st March, 2020. Also compute amount to be debited to P & L account for the year ended 31st March, 2020.

Solution

Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

As at 31st March, 2019 = ₹ 60,000 x .02 + ₹ 40,000 x .03
= ₹ 1,200 + ₹ 1,200
= ₹ 2,400

As at 31st March, 2020 = ₹ 40,000 x .02 + ₹ 1,35,000 x .03
= ₹ 800 + ₹ 4,050
= ₹ 4,850

Amount debited to Profit and Loss Account for year ended 31st March, 2020

Balance of provision required as on 31.03.2020	4,850
Less: Opening Balance as on 1.4.2019	(2,400)
Amount debited to profit and loss account	**2,450**

Note: No provision will be made on 31st March, 2020 in respect of sales amounting ₹ 60,000 made on 11th February, 2018 as the warranty period of 2 years has already expired

Question 3

An airline is required by law to overhaul its aircraft once in every five years. The pacific Airlines which operate aircrafts does not provide any provision as required by law in its final accounts. Discuss with reference to relevant Accounting Standard 29.

Solution

A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29.

The cost of overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts. Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts. Further, the enterprise can avoid the future expenditure by its future action, for example by selling the aircraft. However, an obligation might arise to pay fines or penalties under the legislation after completion of five years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than five years.

Question 4 *(RTP Nov 2020)*

Alpha Ltd. has entered into a sale contract of ₹ 7 crores with Gamma Ltd. during 2019-20 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2020-21 financial year. In case of failure of Alpha Ltd. to deliver within the schedule, a compensation of ₹ 2 crores is to be paid to Gamma Ltd. Alpha Ltd. planned to

manufacture the goods during the last month of 2019-20 financial year. As on balance sheet date (31.3.2020), the goods were not manufactured and it was unlikely that Alpha Ltd. will be in a position to meet the contractual obligation. You are required to advise Alpha Ltd. on requirement of provision for contingency in the financial statements for the year ended 31st March, 2020, in line with provisions of AS 29?

Solution

AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognized. Alpha Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Alpha Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation.
Therefore, Alpha Ltd. should provide for the contingency amounting ₹ 2 crores as per AS 29.

Question 5 *(Inter Nov 2020) (5 Marks) / (RTP Nov 2023)*

With reference to AS 29, how would you deal with the following in the Annual Accounts of the company at the Balance Sheet date:

(i) The company operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Eighty five percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and fifteen percent arise through the extraction of oil. At the balance sheet date, rig has been constructed but no oil has been extracted.

(ii) The Government introduces a number of changes to the taxation laws. As a result of these changes, the company will need to train a large proportion of its accounting and legal workforce in order to ensure continued compliances with tax law regulations. At the balance sheet date, no retraining of staff has taken place

Solution

(i) The construction of the oil rig creates an obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil. An outflow of resources embodying economic benefits in settlement is probable. Thus, a provision is recognized for the best estimate of 85% of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig.
However, there is no obligation to rectify the damage that will be caused by extraction of oil, as no oil has been extracted at the balance sheet date. So, no provision is required for the cost of extraction of oil at balance sheet date. 15% of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

(ii) As per AS 29, a provision for restructuring costs is recognized only when the recognition criteria for provisions are met. A restructuring provision does not include costs as of retraining or relocating continuing staff. The expenditures of training the staff related to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognized on the same basis as if they arose independently of a restructuring. At the balance sheet date, no such expenditure has been incurred hence no provision is required.

Question 6 *(RTP May 2021)*

a) The company has not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. You are required to examine in line with the provisions of AS 29.

b) Explain whether provision is required in the following situations in line with AS 29:

(i) There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation;

(ii) There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.

(iii) There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.

Solution

(a) As per provisions of 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 recognized 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 recognized for the reimbursement should not exceed the amount of the provision. It is apparent from the question that the company had not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. However, the provision for warranty should have been made as per AS 29 and the amount claimable as reimbursement should be treated as a separate asset in the financial statements of the company rather than omitting the disclosure of such liability. Accordingly, it can be said that the accounting treatment adopted by the company with respect to warranty is not correct.

(b)

(i) There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation – Provision is recognised. Disclosures are required for the provision.

(ii) There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources – No provision is recognised. Disclosures are required for the contingent liability.

(iii) There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote – No provision is recognised. No disclosure is required.

Question 7

Saharsh Ltd. is engaged in manufacturing of electric home appliances. The company is in the process of finalizing its accounts for the year ended 31.3.2020 and needs your expert advice on the following issues in line with the provisions of AS 29:

a) A case has been filed against the company in the consumer court and a notice for levy of a penalty of ₹ 20 lakhs has been received. The company has appointed a lawyer to defend the case for a fee of ₹ 2 lakhs. 50% of the fees has been paid and balance 50% will be paid after finalisation of the case. There are 75% chances that the penalty may not be levied.

b) The company had committed to supply a consignment worth ₹ 1 crore to one of its dealers by the year-end. As per the contract, if delivery is not made on time, a compensation of 15% is to be paid on the value of delayed/lost consignment. While the consignment was in transit, one of the trucks carrying goods worth ₹ 30 lakhs met with an accident. It was however covered by Insurance. According to the surveyor's report, the policy amount is

collectable, subject to 10% deduction. Before closing the books of accounts, the company has received the information that the policy amount has been processed and the dealer has also claimed the compensation for the consignment of goods worth ₹ 30 lakhs which was in transit.

Solution

a) As per AS 29, an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. Liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. In the given case, there are 75% chances that the penalty may not be levied. Accordingly, Saharsh Ltd. should not make the provision for penalty. However, a provision should be made for remaining 50% fees of the lawyer in the financial statements of financial year 2019-2020.

b) Loss due to accident ₹ 30,00,000
Insurance claim receivable by company = ₹ 30,00,000 x 90% = ₹ 27,00,000
Loss to be recognised in the books for 2019-2020 ₹ 3,00,000
Insurance claim receivable to be recorded in the books ₹ 27,00,000
Compensation claim by dealer against company to be provided for in the books
= ₹ 30,00,000 x 15% = ₹ 4,50,000

Question 8 *(Inter July 2021) (5 Marks)*

A Limited sells goods with unlimited right of return to its customers. The following pattern has been observed in the Return of Sales:

Time frame of Return from date of purchase	% of Cumulative Sales
Between 0-1 month	6%
Between 1-2 months	7%
Between 2-3 months	8%

The Company has made Sales of ₹ 36 Lakhs in the month of January, ₹ 48 Lakhs in the month of February and of ₹ 60 Lakhs in the month of March. The Total Sales for the Financial Year have been ₹ 400 Lakhs and the Cost of Sales was ₹ 320 Lakhs. You are required to determine the amount of Provision to be made and Revenue to be recognized as on 31st March.

Solution

Amount of provision

The goods are sold with a right to return. The existence of such right gives rise to a present obligation on the company as per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets'. According to the standard, a provision should be created on the Balance sheet date, for sales returns after the Balance Sheet date, at the best estimate of the loss expected, along with any estimated incremental cost that would be necessary to resell the goods expected to be returned.

Sales during	Sales value (₹ in lacs)	Sales value (cumulative) ₹ (in lacs)	Likely returns (%)	Likely returns ₹ (in lacs)	Provision @ 20% (₹ in lacs) (Refer W.N.)
March	60	60	6%	3.60	0.720
February	48	108	7%	7.56	1.512
January	36	144	8%	11.52	2.304
Total				**22.68**	**4.536**

Revenue to be recognized

Revenue in respect of sale of goods is recognized fully at the time of sale itself assumed that the company has complied with the conditions stated in AS 9 relating to recognition of revenue in the case of sale of goods. As per AS 9, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

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

b) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods. AS 9 also provides that in case of retail sales offering a guarantee of 'money back, if not completely satisfied, it may be appropriate to recognize the sale but to make a suitable provision for returns based on previous experiences.

Therefore, sale of ₹ 36 lakhs, ₹ 48 lakhs and ₹ 60 lakhs made in the months of January, February and March will be recognized at full value. Thus, total revenue to be recognized for RS. 400 lacs for the year.

Working Note:

Calculation of Profit % on sales

	(₹ in lacs)
Sales for the year	400
Less: Cost of sales	(320)
Profit Profit mark up on sales (80/400) x 100 = 20%	80

Question 9 *(RTP May 2022)/ (RTP Nov 2022) (Similar)*

Chaos Limited is in the process of finalizing its accounts for the year ended 31st March, 2020. It seeks your advice in the following cases:

(i) Chaos Limited has filed court case in 2014-2015 against its competitors. It became evident to its lawyers during the year ended 31st March, 2020 that Chaos Limited may lose the case and would have to pay ₹ 3,00,000 being the cost of litigation. No entries/provisions have been made in the books.

(ii) A new regulation has been passed in 2019-2020 by the healthcare ministry to upgrade facilities. Deadline set by the government is 31.03.2021. The company estimates an expenditure of ₹ 10,00,000 for the said upgrade.

(iii) The company gives one year warranty for its healthcare equipment under the contract of sale that it will make good any manufacturing defect by repair or replacement. As per past experience, it is probable that there will be 1% such cases and estimated cost of repair / replacement is estimated at 10% of such sale value. During the year, the company has made a sale of ₹ 5 crores.

Kindly give your answer for each of above with proper reasoning according to the relevant Accounting Standard. Also state the principles for recognition of provision, as per AS 29.

Solution

Principles for recognition of provisions: As per AS 29, "a provision shall be recognised when:

a) an entity has a present obligation (legal or constructive) as a result of a past event;

b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised."

Accounting treatment under the given scenarios:

(i) On 31st March, 2020, since it is evident to the lawyer that Chaos Limited may lose the case and also a reliable estimate of the outflow can be made as ₹ 3,00,000, there is a present obligation. Hence, provision should be recognised for ₹ 3,00,000 for the amount which may be required to settle the obligation.

(ii) Under new regulation, an entity is required to upgrade its facilities by 31st March, 2021. However, on 31st March, 2020, i.e. at the end of the reporting period, there is no obligation because there is no obligating event either for the costs of upgrading the facilities or for fines under the regulations. Hence, no provision should be recognized on 31st March, 2020 for upgrading the facilities by 31st March, 2021.

(iii) The obligating event is the sale of health care equipment with a warranty, which gives rise to a legal obligation. Here, an outflow of resources embodying economic benefits in settlement is probable for the warranties as a whole. Hence, a provision is recognized for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period as follows:
Probability of warranty cases for the entity where repair/replacement may be required as per past experience = 1% of ₹ 5,00,00,000 = ₹ 5,00,000
Estimated cost of repair / replacement = ₹ 5,00,000 x 10% = ₹ 50,000.

Question 10 *(Inter May 2022) (5 Marks)*

Alloy Fabrication Limited is engaged in manufacturing of iron and steel rods. The company is in the process of finalization of the accounts for the year ended 31st March,2022 and needs your advice on the following issues in line with the provisions of AS-29:

(i) On 1st April,2019, the company installed a huge furnace in their plant. The furnace has a lining that needs to be replaced every five years for technical reasons. At the Balance Sheet date 31st March,2022, the company does not provide any provision for replacement of lining of the furnace.

(ii) A case has been filed against the company in the consumer court and a notice for levy of a penalty of ₹ 50 Lakhs has been received. The company has appointed a lawyer to defend the case for a fee of ₹ 5 Lakhs. 60% of the fees have been paid in advance and rest 40% will be paid after finalization of the case. There are 70% chances that the penalty may not be levied.

Solution

(i) A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29. The cost of replacement of lining of furnace is not recognized as a provision because it is a future obligation. Even a legal requirement does not require the company to make a provision for the cost of replacement because there is no present obligation. Even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

(ii) As per AS 29, an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. Liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
In the given case, there are 70% chances that the penalty may not be levied. Accordingly, Alloy Fabrication Ltd. should not make the provision for penalty. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.
However, a provision should be made for remaining 40% fees of the lawyer amounting ₹ 2,00,000 in the financial statements of financial year 2021-2022.