Referencer for Quick Revision

Intermediate Course Paper-5: Advanced Accounting

A compendium of subject-wise capsules published in the monthly journal "The Chartered Accountant Student"

Board of Studies
(Academic)
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INDEX

A CAPSULE ON ACCOUNTING STANDARDS FOR QUICK RECAP

It has always been the endeavour of Board of Studies to provide quality academic inputs to the students. Considering this objective in mind, it has been decided to bring forth a crisp and concise capsule for the topic on Accounting Standards covered in Intermediate Paper 5 "Advanced Accounting". The significant provisions of AS 7, AS 9, AS 14, AS 18, AS 19, AS 20, AS 24, AS 26 and AS 29 have been gathered and presented through pictorial presentations in this capsule which will help the students in grasping the intricate practical aspects of each Accounting Standard. Although, the capsule has been prepared keeping in view the new and revised scheme of Education and Training of ICAI, the students of earlier scheme may also be benefitted from it. This capsule, though, facilitates the students in undergoing quick revision, under no circumstances, such revisions can substitute the detailed study of the material provided by the Board of Studies.

AS 7 "CONSTRUCTION CONTRACTS"

AS 7 prescribes the principles of accounting for construction contracts in the financial statements of contractors. The focus of the standard is on allocation of contract revenue and contract costs to the accounting periods in which construction work is performed.

What are Construction Contracts?

- Contracts specifically negotiated for the construction of an asset or combination of assets that are closely interrelated.
- Contracts for rendering of services related to construction of assets.
- Contracts for destruction or restoration of assets.

Construction contracts can be classified into two categories.

Types of construction contracts

- Fixed price contract — Contractor agrees to a fixed contract price or fixed rate per unit of output, which in some cases is subject to cost escalation.
- Cost plus contract — Contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

If the final outcome of the contract

- Can be estimated reliably — Revenue and costs recognized as per percentage of completion method considering the stage of completion of contract at reporting date.
- Can not be estimated reliably
  - Revenue should be recognized only to the extent of contract costs incurred, of which recovery is probable.
  - Contract costs should be recognised as an expense in the period in which they are incurred.

Note: Any expected loss (when contract cost > contract revenue) on the construction contract should be recognised as an expense immediately in both the situations.

AS 7 prescribes conditions under which the outcome of a contract can be estimated reliably.

Outcome of contracts can be estimated reliably when

- In fixed price contract
  - Total contract revenue can be measured reliably.
  - It is probable that the economic benefits associated with the contract will flow to the enterprise.
  - Both contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably.
  - Contract costs attributable to contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.
- In cost plus contract
  - It is probable that the economic benefits associated with the contract will flow to the enterprise.
  - Contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Methods for Determination of Stage of Completion of Contracts

Determination of Stage of Completion (Method to be chosen depending on the nature of the contract)		
Proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs	Surveys of work performed	Completion of a physical proportion of the contract work

As per the standard, Contract revenue and Contract costs comprise of the following:

Contract Revenue

Initial amount of revenue agreed in the contract.	Variations in contract work, claims and incentive payments if (i) it is probable that they will result in revenue. (ii) they are capable of being reliably measured.

Contract Costs

Costs that relate directly to the specific contract.	Costs that are attributable to contract activity in general and can be allocated to the contract.	Such other costs as are specifically chargeable to the customer under the terms of the contract.

Changes in Estimates

- Application of percentage of completion on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs.
- Effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate.
- The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

When a contract covers a number of assets, each contract should be treated as separate contract if

- Separate proposals have been submitted for each asset.
- Each asset has been subject to separate negotiation and contractor and customers are able to accept or reject that part of the contract relating to each asset.
- Costs and revenues of each asset can be identified.

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

- Group of contracts is negotiated as a single package.
- Contracts are performed concurrently or in a continuous sequence.
- Contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin.

A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset.

Construction of the additional asset should be treated as a separate construction contract when

- Asset differs significantly in design, technology or function from the asset or assets covered by the original contract
- Price of the asset is negotiated without regard to the original contract price.

Disclosures in Financial Statements

General	Specific for contracts in progress
Amount of contract revenue recognised as revenue in the period	Amount of advances received
Methods used to determine the stage of completion of contracts in progress	Amount of retentions

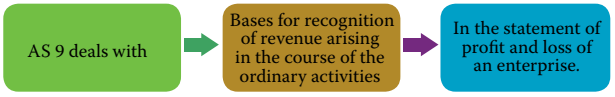
Retentions are the amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

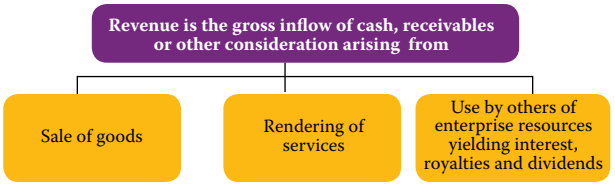
An enterprise should present gross amount for contract work in the financial statements

- Due from customers — As an asset
- Due to customers — As a liability

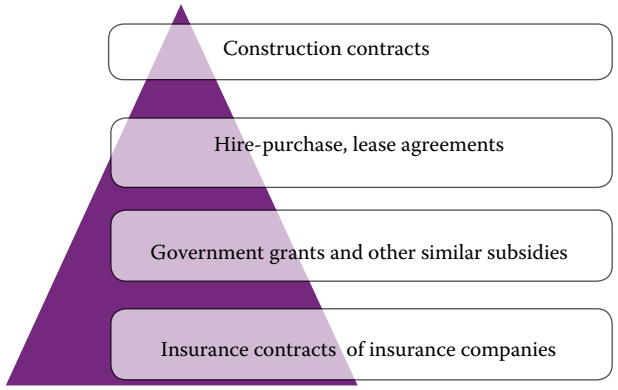
AS 9 "REVENUE RECOGNITION"

AS 9 explains the timing for recognition of revenue in the financial statements and also state the circumstances under which revenue recognition should be postponed.



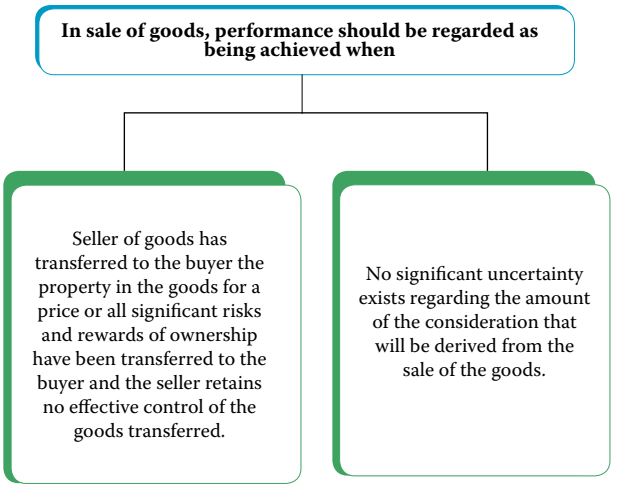


AS 9 does not deal with reveue arising from



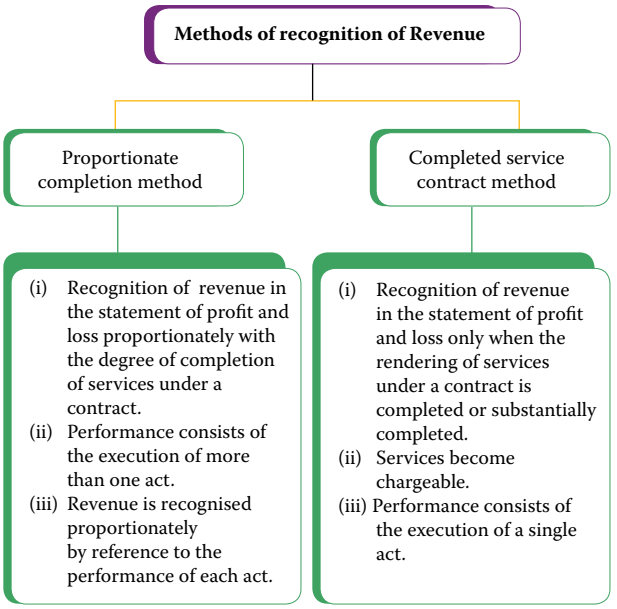
Sale of Goods

Revenue from sale of goods should be recognised when the requirements as to performance as set out in the standard are satisfied.



Rendering of Services

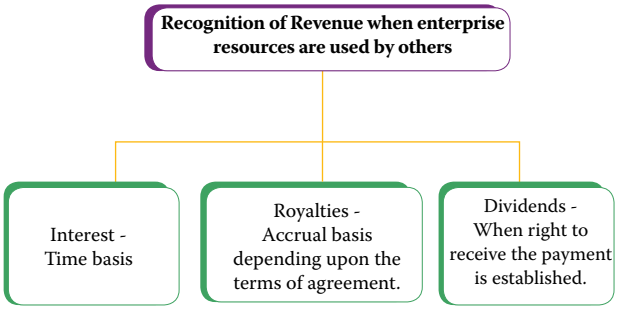
Revenue from service transactions is usually recognised as the service is performed.



Note: Revenue from Sale of goods "for consideration" and Service transactions should be recognized only when no significant uncertainty exists regarding amount of consideration.

Use of Enterprise Resources by Other Parties

Use of enterprise resources by others may yield revenue in the form of Interest, Royalties and Dividends.



Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

Disclosures

In addition to the disclosures required by AS 1 "Disclosure of Accounting Policies", an enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

AS 14 "ACCOUNTING FOR AMALGAMATIONS"

AS 14 (Revised) deals with the accounting to be made in the books of Transferee company in the case of amalgamation and the treatment of any resultant goodwill or reserve.

Objective

- Accounting for amalgamations
- Treatment of any resultant goodwill or reserves
- Disclosures

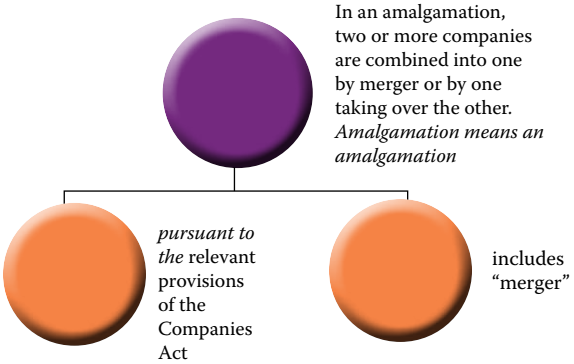
Scope

This standard deals with Accounting for Amalgamation i.e. acquisition of one entity by the other and the acquired entity ceased to exist

The standard does not deal with cases of acquisitions where one entity is acquired by the other and the acquired entity continues to exist.

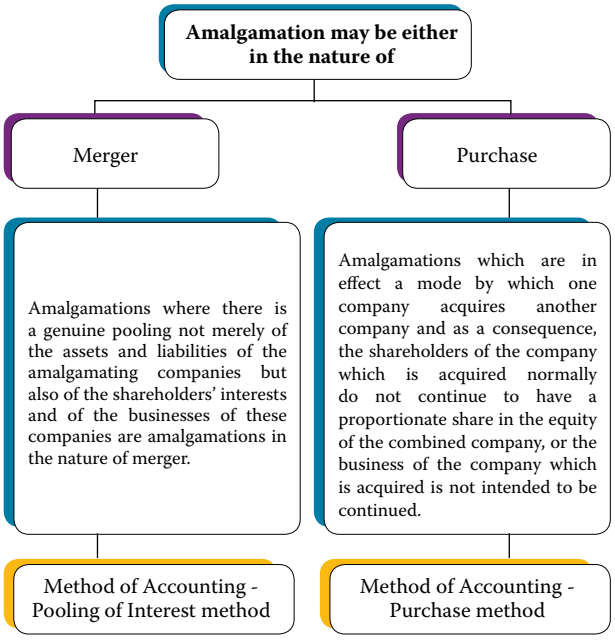
Key Terms

Meaning of Amalgamations



Transferor company	Company which is amalgamated into another company.
Transferee company	Company into which a transferor company is amalgamated.
Reserve	Portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.
Consideration for the amalgamation	Aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.
Fair value	Amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

Types of Amalgamations and Methods of Accounting



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

Conditions for Amalgamation in the nature of Merger and Purchase

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

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

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

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

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

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

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

Methods of Accounting

Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either

- By incorporating the assets and liabilities at their existing carrying amounts or
- By allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation.

Pooling of Interests Method

Pooling of interests is a method of accounting for amalgamations, the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company.

1. Assets, liabilities and reserves of the transferor company to be recorded by the transferee company at existing carrying amounts and in the same form as at the date of the amalgamation.
2. If the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies should be adopted following the amalgamation.
3. The difference between the amount of share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves.

Treatment of Reserves of the Transferor Company on Amalgamation

Treatment of Reserves

- **Amalgamation in nature of merger**: Identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company.
- **Amalgamation in the nature of purchase**: Identity of the reserves, other than the statutory reserves is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

Statutory Reserves

Statutory reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute.

Statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g. 'Amalgamation Adjustment Reserve') which is presented as a separate line item under the head "**Reserves and Surplus**".

When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

Balance of Profit and Loss Account

Balance of the Profit and Loss Account appearing in the financial statements of the transferor company

- **Amalgamation in nature of merger**:
  - Is aggregated with the corresponding balance appearing in the financial statements of the transferee company.
  - Alternatively, it is transferred to the General Reserve, if any.
- **Amalgamation in the nature of purchase**:
  - Debit or credit balance loses its identity.

Treatment of Goodwill

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised on a systematic basis over its useful life.

Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty.

It is considered appropriate to amortise goodwill over a period not exceeding 5 years unless a longer period can be justified.

Disclosure Requirements

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

- Names and general nature of business of the amalgamating companies;
- Effective date of amalgamation for accounting purposes;
- Method of accounting used to reflect the amalgamation; and
- Particulars of the scheme sanctioned under a statute.

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

- Description and number of shares issued, together with the percentage of each company's equity shares exchanged to effect the amalgamation; and
- Amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

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

- Consideration for the amalgamation and a description of the consideration paid or contingently payable; and
- Amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

AS 18 "RELATED PARTY DISCLOSURES"

AS 18 prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

Related Parties and Related Party Relationships

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 in sitiuations when:

(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

(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.

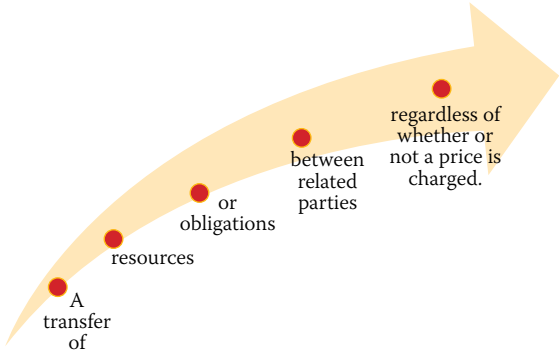
In the context of AS 18, following are deemed not to be related parties:

- 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).
- A single customer, supplier, franchiser, distributor or general agent with whom an enterprise transacts a significant volume of business.
- Providers of finance, Trade unions, Govt. agencies and public utilities in the course of their normal dealings with an enterprise.

No disclosure is required in consolidated financial statements in respect of intra-group transactions.

Key Terms

Related Party Transaction



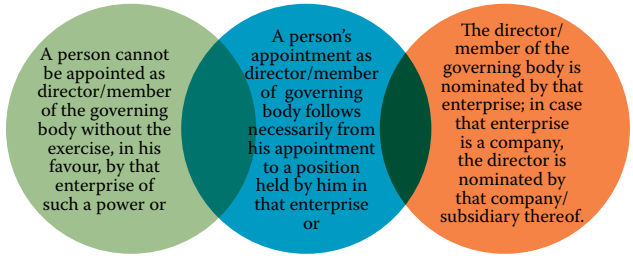
Control

Control includes

- Ownership, directly or indirectly, of more than one half of the voting power of an enterprise
- 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
- Substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

For the purpose of AS 18, an enterprise is considered to **control the composition** of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of the governing body of that company/enterprise.

An enterprise is deemed to have the power to appoint a director/ member of the governing body, if any of the following conditions are satisfied:

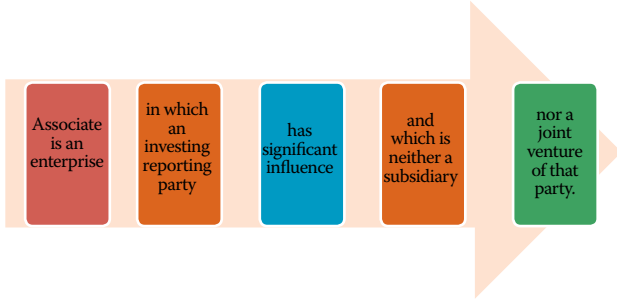


Substantial Interest

An enterprise/individual is considered to have a substantial interest in another enterprise if

- That enterprise or individual owns, directly or indirectly, 20% or more interest in the voting power of the other enterprise
- That individual owns, directly or indirectly, 20% or more interest in the voting power of the enterprise.

Associate



Significant Influence

Significant influence is participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies.

Significant influence may be gained by share ownership, statute or agreement.

As regards share ownership, if an investing party holds, directly or indirectly, through intermediaries, 20% or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case.

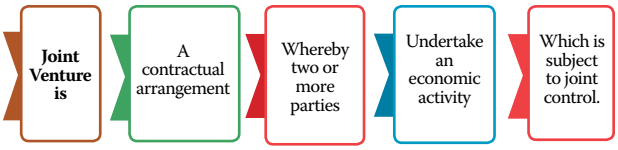
A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

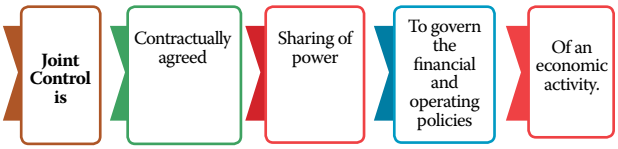
Key Management Personnels are

Those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

In relation to an individual, Relative means

Joint Venture and Joint Control

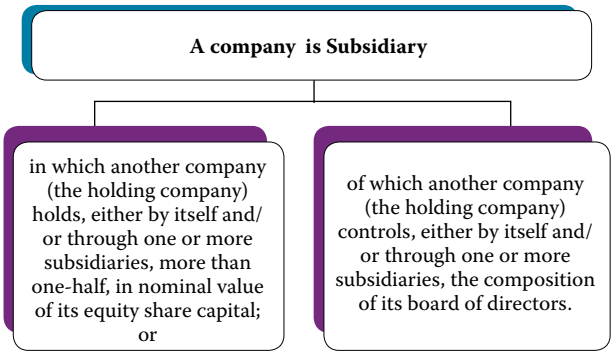




Holding Company

A company having one or more subsidiaries is a holding company.

Subsidiary Company



Fellow Subsidiary

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.

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

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:

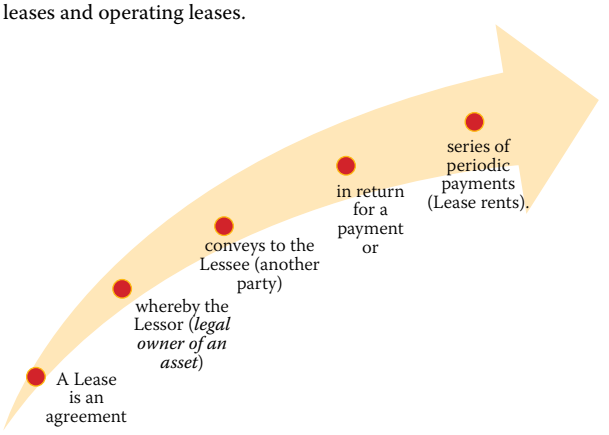
- The name of the transacting related party;
- A description of the relationship between the parties;
- A description of the nature of transactions;
- Volume of the transactions either as an amount or as an appropriate proportion;
- Any other elements of the related party transactions necessary for an understanding of the financial statements;
- Amounts or appropriate proportions of outstanding items pertaining to related parties at 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.

Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

AS 19 "LEASES"

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



Scope

AS 19 applies to all leases other than:

- Lease agreements to explore for or use of 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.
- Agreements that are contracts for services, that do not transfer right to use assets from one contracting party to the other.

Key Terms

Non-cancellable lease is a lease that is cancellable

- Upon the occurrence of some remote contingency; or
- With the permission of the lessor; or
- 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.

The **lease term is the non-cancellable period** for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum Lease Payments

Minimum lease payments are

the payments over the lease term

that the lessee is

to make excluding contingent rent,

costs for services and

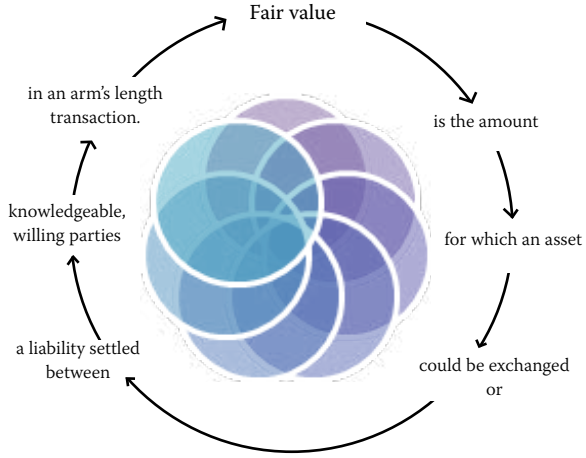
taxes to be paid by and

reimbursed to the lessor,

together with:
(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or
(b) in the case of the lessor, any residual value guaranteed to the lessor:
(i) by or on behalf of the lessee; or
(ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

Fair Value



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: Period over which the leased asset is expected to be used by the lessee; OR Number of production or similar units expected to be obtained from the use of the asset by the lessee.

Residual Value

Residual value is the estimated fair value at the end of the lease term.

Guaranteed Residual Value

Guaranteed residual value 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 (the amount of the guarantee being the maximum amount that could, in any event, become payable).

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

Amount by which the residual value of the asset Exceeds Its guaranteed residual value.

Gross Investment

Aggregate of Minimum lease payments Under a finance lease From the standpoint of the lessor.

Unearned Finance Income

Difference between:

Gross investment in the lease; and

Present value of

(i) Minimum lease payments under a finance lease from the standpoint of the lessor; and
(ii) Any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Net investment in the lease is the gross investment in the lease **less** unearned finance income.

Interest rate implicit in the lease

Discount rate that, at the inception of the lease, causes the aggregate 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, to be equal to the fair value of the leased asset.

Lessee's Incremental Borrowing Rate of Interest

is the rate of interest
the lessee would have to pay on a similar lease or,
if that is not determinable,
the rate that, at the inception of the lease,
the lessee would incur to borrow over a similar term
and with a similar security, the funds necessary to purchase the asset.

Contingent Rent

Contingent rent is that portion of the lease payment

that is not fixed in amount but is based on a factor

other than just the passage of time

Types of Leases

For accounting purposes, leases are classified as

- **Finance leases**: A lease that transfers substantially, all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred.
- **Operating leases**: A lease is classified as an *Operating Lease,* if it does not transfer substantially all the risk and rewards incident to ownership.

Indicators of Finance Lease

Situations, which would normally lead to a lease being classified as a finance lease are:

- Lease transfers ownership of the asset to the lessee by the end of the lease term.
- Lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.
- Lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception of the lease, present value of the minimum lease payment amounts to at least substantially all of the fair value of the leased asset.
- Leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

- 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
- If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term.

Accounting for Finance Leases (Books of Lessee)

On the date of inception of lease, lessee should show it as an asset and corresponding liability at lower of:

(i) Fair value of leased asset at the inception of the lease

(ii) Present value of minimum lease payments from the standpoint of the lessee (present value to be calculated with discount rate equal to interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used). Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.

A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in AS 10 (Revised), Property, Plant and Equipment. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

Computation of Interest Rate implicit on Lease (IRR)

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate 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, to be equal to the fair value of the leased asset.

Disclosures made by the Lessee in case of Finance Lease

The lessee should, in addition to the requirements of AS 10 (Revised) 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) 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 the statement of profit and loss for the period;

(e) Total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date; and

(f) 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.

Accounting for Finance Leases (Books of Lessor)

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.
In a finance lease, the lessor recognises the net investment in lease which is usually equal to fair value as receivable by debiting the Lessee A/c.

Recognition of Finance Income

The unearned finance income is recognised over the lease term based on a pattern reflecting a constant periodic return on the net investment in lease outstanding.

Initial Direct Costs

For finance leases, initial direct costs incurred to produce finance income are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

Review of Unguaranteed Residual Value by Lessor

AS 19 requires a lessor to review unguaranteed residual value used in computing the gross investment in lease regularly. In case any reduction in the estimated unguaranteed residual value is identified, the income allocation over the remaining lease term is to be revised. An upward adjustment of the estimated residual value is not made.

Manufacturer or Dealer Lessor

The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales.

Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Disclosures

The lessor should make the following disclosures for finance leases:

(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) Unguaranteed residual values accruing to the benefit of the lessor;

(d) Accumulated provision for uncollectible minimum lease payments receivable;

(e) Contingent rents recognised in the statement of profit and loss for the period;

(f) General description of the significant leasing arrangements of the lessor;

(g) Accounting policy adopted in respect of initial direct costs.

Accounting for Operating Leases

Accounting treatment in the Books of lessee

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee 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.

Disclosures by Lessees

Lessees are required to make following disclosures for operating leases:

(a) 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) 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) 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.

Accounting Treatment in the books of Lessor

The lessor should present an asset given under operating lease as fixed assets in its balance sheets.

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.

Depreciation of leased assets should be charged in books of lessor on a basis consistent with the normal depreciation policy of the lessor for similar assets.

The impairment losses on assets given on operating leases are determined and treated as per AS 28*.

Disclosures by Lessors

As per AS 19, the lessor should, in addition to the requirements of AS 10 (Revised)* 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 the balance sheet date; and
(i) the depreciation recognised in the statement of profit and loss for the period;
(ii) impairment losses recognised in the statement of profit and loss for the period;
(iii) impairment losses reversed in the statement of profit and loss for the period;

(b) Future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:
(i) not later than one year;
(ii) later than one year and not later than five years;
(iii) later than five years;

(c) Total contingent rents recognised as income in the statement of profit and loss for the period;

(d) General description of the lessor's significant leasing arrangements; and

(e) Accounting policy adopted in respect of initial direct costs.

Sale and Leaseback

One vendor sells an asset for cash and then takes it back from the buyer on lease.

Lessee or seller receives cash immediately and makes periodic payment in the form of lease rents for right to use the property.

Accounting treatment of a sale and lease back depends upon the type of lease involved.

Lease payments and the sale price are generally interdependent as they are negotiated as a package.

** AS 10 and AS 28 are not covered in the syllabus of Paper 5.*

Where sale and leaseback results in finance lease

The excess or deficiency of sales proceeds over the carrying amount should not be recognized immediately but deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Where sale and leaseback results in operating lease

Case 1: Sale price = Fair Value

Profit or loss should be recognised immediately.

Case 2: Sale Price < Fair Value

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

Case 3: Sale Price > Fair Value

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

If the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

Sale price established at fair value	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	No profit	Recognise profit immediately	Not applicable
Loss	No loss	Not applicable	Recognise loss immediately
Sale price below fair value (paragraph 50)			

Sale price established at fair value	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	No profit	Recognise profit immediately	No profit (note 1)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	Recognise loss immediately	(note 1)
Loss compensated by future lease payments at below market price	Defer and amortise loss	Defer and amortise loss	(note 1)
Sale price above fair value (paragraph 50)			
Profit	Defer and amortise profit	Defer and amortise profit	Defer and amortise profit (note 2)
Loss	No loss	No loss	(note 1)

***Note 1*:** Circumstances that require the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

***Note 2*:** Profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with AS 19.

AS 20 "EARNINGS PER SHARE"

The objective of AS 20

is to describe principles

for determination and presentation

of earnings per share

which will improve comparison of performance

among different enterprises

for the same period and

among different accounting periods

for the same enterprise.

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

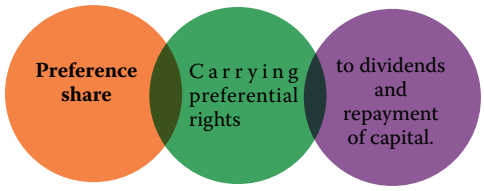
This Accounting Standard is mandatory for all companies. However, disclosure of diluted earnings per share (both including and excluding extraordinary items) is not mandatory for SMCs.

In consolidated financial statements, the information required by AS 20 should be presented on the basis of consolidated information.

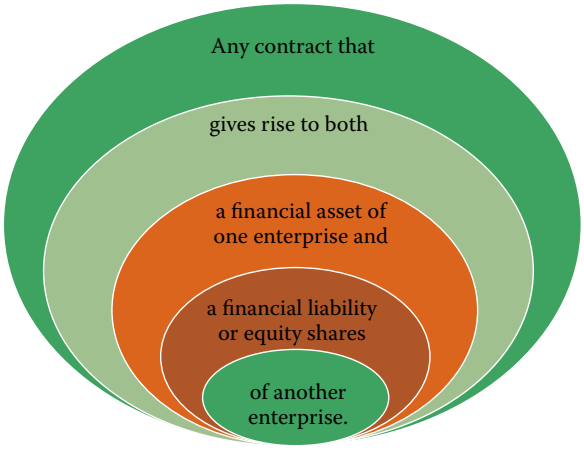
Key Terms

Equity Shares

Preference Share



A Financial Instrument



Financial Asset

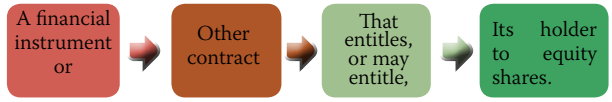
A financial asset is any asset that is

- Cash
- A contractual right to receive cash or another financial asset from another enterprise
- A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or
- An equity share of another enterprise.

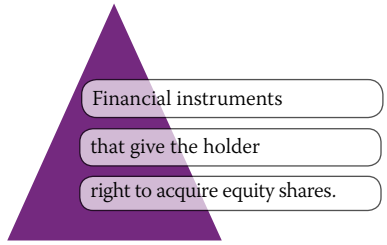
Financial Liability

- Any liability that is a
- Contractual obligation to deliver cash or another financial asset
- To another enterprise or to exchange financial instruments
- With another enterprise under conditions that are potentially unfavourable.

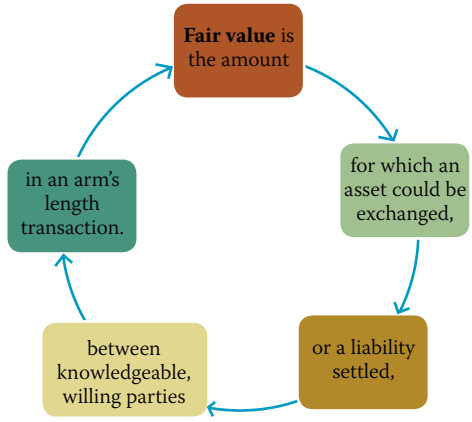
Potential Equity Share



Share Warrants or Options



Fair Value



Basic Earnings Per Share

Basic earnings per share is calculated as

$$\frac{\text{Net profit (loss) attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the period}}$$

For calculating basic earnings per share, the **net profit or loss for the period attributable to equity shareholders** should be the net profit or loss after deducting preference dividends and any attributable tax thereto for the period.

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period.

Amount of preference dividends for the period that is deducted from the net profit for the period is:	Amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and
	Full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Earnings Per Share

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

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

Partly paid equity shares

- (i) Are treated as a fraction of an equity share
- (ii) to the extent that they were entitled
- (iii) to participate in dividends
- (iv) relative to a fully paid equity share

Where an enterprise has equity shares of **different nominal values** but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

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

In a **rights issue**, the exercise price is often less than the fair value of the shares. A rights issue usually includes a bonus element.

The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

Diluted Earnings per Share

Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

- The net profit for the period attributable to equity shares is:
  - Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;
  - Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and
  - Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.
- The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

(a) A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive.
(b) A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding.

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.

In considering whether potential equity shares are dilutive or anti-dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate.

Potential equity shares are weighted for the period they were outstanding.

Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented.

If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares.

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.

AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative .

Disclosure

An enterprise should disclose

- Where the statement of profit and loss includes extraordinary items basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense).
- 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.
- 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.
- The nominal value of shares along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with AS 20.

AS 24 "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

- That the enterprise, pursuant to a single plan*
- That represents a separate major line of business or geographical area of operations
- That can be distinguished operationally and for financial reporting purposes.

*(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 or*
(ii) *Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or*
(iii) *Terminating through abandonment.*

To qualify as a discontinuing operation, the disposal must be pursuant to a single coordinated plan.

A component can be distinguished operationally and for financial reporting purposes if these conditions are met:

- Operating assets and liabilities of the component can be directly attributed to it.
- Its revenue can be directly attributed to it.
- Majority of its operating expenses can be directly attributed to it.

Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it.

Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.

Initial Disclosure Event

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the events, whichever occurs earlier:

- Enterprise has entered into a binding sale agreement for substantially all of the assets attributable to discontinuing operation or
- Enterprise's board of directors or similar governing body has
  - Approved a detailed, formal plan for the discontinuance and
  - Made an announcement of the plan.

Recognition and Measurement

This AS does not provide any guidelines

- For recognizing and measuring,
- Effect of discontinuing operations,
- Relevant Accounting Standards should be referred.

Presentation and Disclosure

Initial Disclosure

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

- A description of the discontinuing operation(s).
- The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.
- The business or geographical segment(s) in which it is reported.
- 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 date and nature of the initial disclosure event.
- The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period.
- 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.

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:

- 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
  - (ii) income tax expense relating to the gain or loss
- 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.

The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.

If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed.

Separate disclosure for each discontinuing operation

Any disclosures required by AS 24 should be presented separately for each discontinuing operation.

Presentation of the Required Disclosures

All disclosures should be presented in the notes to the financial statements except these disclosures which should be shown on the face of the statement of profit and loss:

- 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 amount of the pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to the 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.

Disclosure in Interim Financial Reports

Disclosures in an interim financial report in respect of a discontinuing operation

- Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and
- Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

AS 26 "INTANGIBLE ASSETS"

The objective of AS 26 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. AS 26 also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

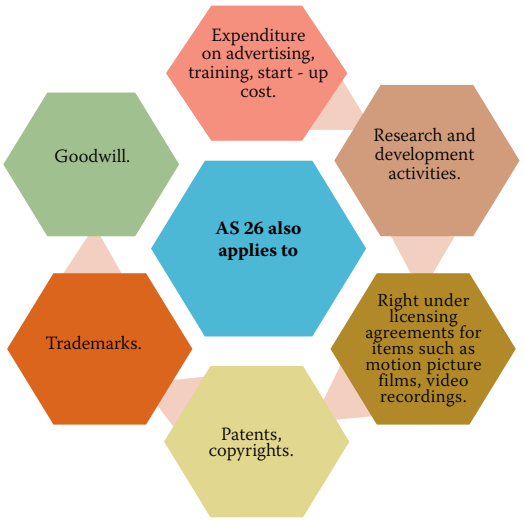
Scope

AS 26 should be applied by all enterprises in accounting for intangible assets, except

- Intangible assets that are covered by another Accounting Standard.
- Financial assets.
- Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources.
- Intangible assets arising in insurance enterprises from contracts with policyholders.

AS 26 applies to

- Other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises.



Key Terms

Asset

An asset is a resource:

Controlled by an enterprise as a result of past events and

From which future economic benefits are expected to flow to the enterprise.

Monetary Assets

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Non-monetary assets are assets other than monetary assets.

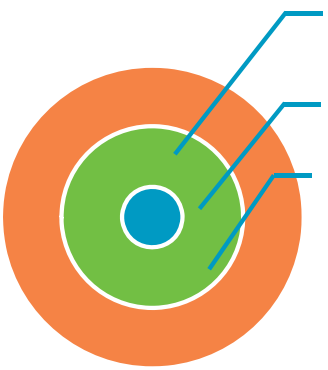
Amortisation

The systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciable Amount

The cost of an asset **Less** its residual value.

Useful Life



Useful life is either

(a) Period of time over which an asset is expected to be used by the enterprise; or

(b) Number of production or similar units expected to be obtained from the asset by the enterprise.

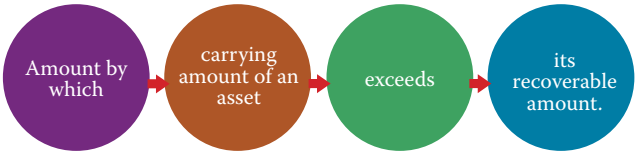
Fair Value

Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An Active Market

- A market where all the conditions exist
- Items traded within the market are homogeneous.
- Willing buyers and sellers can normally be found.
- Prices are available to the public.

Impairment Loss

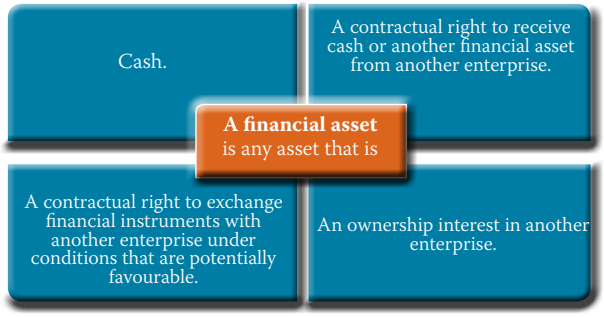


Carrying Amount

Amount at which an asset is recognised in the balance sheet,

net of any accumulated amortisation and accumulated impairment losses thereon.

Financial Asset



Intangible Assets

An intangible asset is

An identifiable Non-monetary asset

Without physical substance

Held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

If an item covered by AS 26 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

Identifiability

The definition of an intangible asset requires that an intangible asset be *identifiable*. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill.

An intangible asset can be clearly distinguished from goodwill if the asset is *separable*. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

If an asset generates *future economic benefits* only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.

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. Hence, these items don't even qualify as intangible asset.

Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. Use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

The recognition of an item as an intangible asset requires an enterprise to demonstrate

- It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise
- The cost of the asset can be measured reliably.

An intangible asset should be measured initially at cost.

Separate Acquisition

If an intangible asset is acquired separately; cost of the intangible asset can usually be measured reliably.

Cost of an intangible asset comprises its purchase price including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the asset ready for its intended use.

If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise: asset is recorded at its fair value or the fair value of the securities issued whichever is more clearly evident.

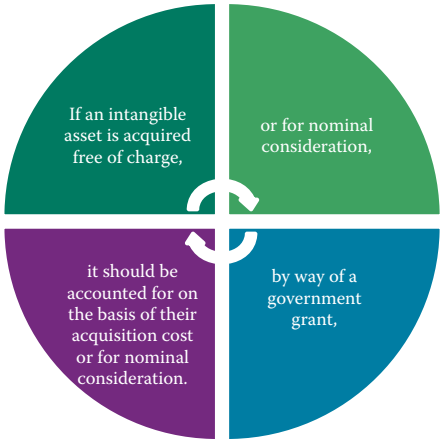
Acquisition as part of an Amalgamation

Intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14 (Revised).

A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and

If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Acquisition by way of a Government Grant



Internally Generated Goodwill

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.

Internally Generated Intangible Assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into

- Research Phase
- Development Phase

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. Its intention to complete the intangible asset and use or sell it.

c. Its ability to use or sell the intangible asset.

d. How the intangible asset will generate probable future economic benefits.

e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and

f. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

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.

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, for creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes

- Expenditure on materials and services used or consumed in generating the intangible asset.
- Salaries, wages and other employment related costs of personnel directly engaged in generating asset.
- Any expenditure that is directly attributable to generating the asset.
- Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset.

The costs which are not components of the cost of an internally generated intangible asset:

- Selling, administrative and 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 recognised as an expense when it is incurred unless:

- It forms part of the cost of an intangible asset that meets the recognition criteria.
- The item is acquired in an amalgamation in the nature of purchase and cannot be recognized as an intangible asset.

In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. Expenditure on research is always recognised as an expense when it is incurred.

Expenses recognised as expenses cannot be reclassified as cost of intangible asset in later years.

Nature of Expenditure	Accounting treatment
Planning	Expense when incurred
Application and Infrastructure Development	Apply the requirements of AS 10
Graphical Design and Content Development	If a separate asset is not identifiable, then expense when incurred, unless it meets the recognition criteria
Operating	Expense when incurred, unless in rare circumstances it meets the criteria, in which case the expenditure is included in the cost of the web site
Other	Expense when incurred

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
- Expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement Subsequent to Initial Recognition

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Amortisation Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use.

AS 26 adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

- Amortises the intangible asset over the best estimate of its useful life.
- Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and
- Discloses the reasons why the presumption is rebutted and the factors that played a significant role in determining the useful life of the asset.

Amortisation Method

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the *straight-line method*, the *diminishing balance method* and the *unit of production method*. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period.

Residual Value

Residual value is the amount, which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

The residual value of an intangible asset should be assumed to be zero unless

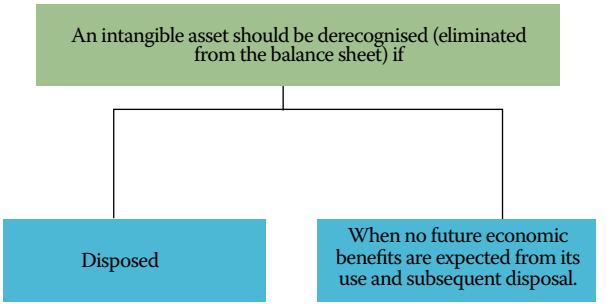
- There is a commitment by a third party to purchase the asset at the end of its useful life.
- There is an active market for the asset and:
  - i. Residual value can be determined by reference to that market and
  - ii. It is probable that such a market will exist at the end of the asset's useful life.

Review of Amortisation Period and Amortisation Method

The amortisation period and the amortisation method should be reviewed at least at each financial year end.

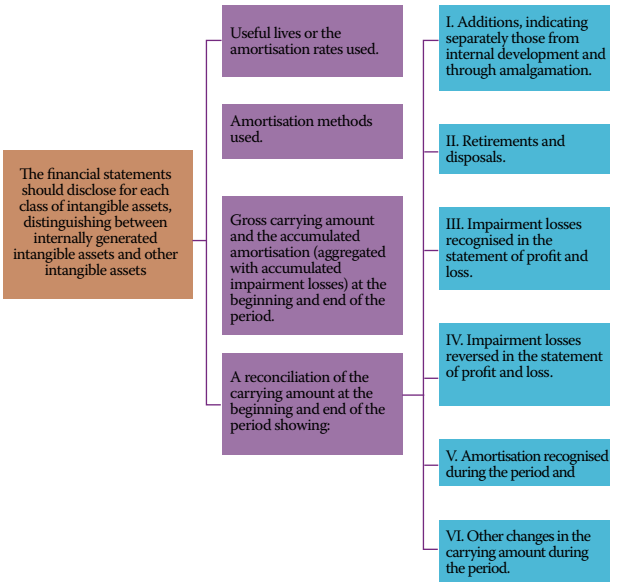
If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern.

Retirements and Disposals



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



Other Disclosure

The financial statements should also disclose:

a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use.

b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.

c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and

d. The amount of commitments for the acquisition of intangible assets.

AS 29 "PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS"

AS 29 lays down appropriate accounting for contingent assets. The objective of AS 29 (Revised) is to ensure appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities.

Scope

AS 29 should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, other than

- Those resulting from financial instruments that are carried at fair value;
- Those resulting from executory contracts except where the contract is onerous*;
- Those arising in insurance enterprises from contracts with policy-holders; and
- Those covered by another Accounting Standard.

** An 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.*

Key Terms

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

A **Provision** is a liability which can be measured only by using a substantial degree of estimation.

A **Liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An **Obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A **Contingent liability is**:

- (a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) A present obligation that arises from past events but is not recognised because
  - (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - (ii) A reliable estimate of the amount of the obligation cannot be made.

A **Contingent asset** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A **Restructuring** is a programme that is planned and controlled by management, and materially changes either:

(a) The scope of a business undertaken by an enterprise; or
(b) The manner in which that business is conducted.

Provisions

A provision should be recognised when:

- (a) An enterprise has a present obligation as a result of a past event;
- (b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- (c) A reliable estimate can be made of the amount of the obligation.

Present Obligation

An enterprise should determine whether a present obligation exists at the balance sheet date by taking account of all available evidence.

Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Past Event

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

No provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

It is only those obligations arising from past events existing independently of an enterprise's future actions that are recognised as provisions.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

Probable Outflow of Resources Embodying Economic Benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. An outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable Estimate of the Obligation

The use of estimates is an inherent part of preparing financial statements and does not undermine their reliability. Provisions require a greater degree of estimation than most other items, but it should not be impossible to determine a range of possible outcomes.

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability will, instead, be disclosed as a contingent liability.

Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

Contingent Assets

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised.

A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority where an inflow of economic benefits is probable.

Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised.

Table- Provisions and contingent liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of:
(a) a present obligation the one whose existence at the balance sheet date is considered probable; or
(b) a possible obligation the existence of which at the balance sheet date is considered not probable.

There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	*There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.*	*There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.*
A provision is recognised. Disclosures are required for the provision.	No provision is recognised. Disclosures are required for the contingent liability.	No provision is recognised. No disclosure is required.

Measurement- Best Estimate

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

Risks and Uncertainties

The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

Future Events

It is only those obligations arising from past events that exist independently of the enterprise's future actions that are recognised as provisions.

Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted.

Expected Disposal of Assets

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

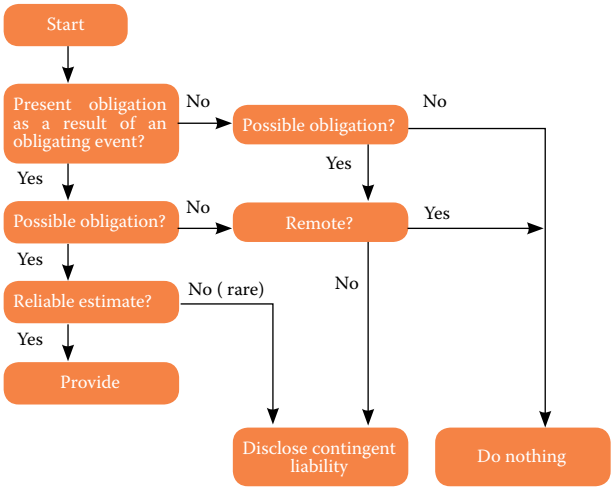
Reimbursements

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.

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.

The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	*The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.*	*The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.*
The enterprise has no liability for the amount to be reimbursed.	The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability.	The expected reimbursement is not recognised as an asset.
No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement.	The expected reimbursement is disclosed.

Decision Tree



Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Note: As per the amendment made in AS 29 (Revised) pursuant to MCA notification dated 30 March 2016, effective from financial year 2016-17, all the existing provisions for decommissioning, restoration and similar liabilities should be discounted prospectively, with the corresponding effect to the related item of property, plant and equipment.

Use of Provisions

A provision should be used only for expenditures for which the provision was originally recognised. Only expenditures that relate to the original provision are adjusted against it.

Application of the Recognition and Measurement Rules

Future Operating Losses

Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future operating losses.

Restructuring

The following are examples of events that may fall under the definition of restructuring:

- Sale or termination of a line of business
- Closure of business locations in a country or region or the relocation of business activities.
- Changes in management structure.
- Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the recognition criteria for provisions 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.

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

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

Gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

For each class of provision, an enterprise should disclose:

- Carrying amount at the beginning and end of the period;
- Additional provisions made in the period, including increases to existing provisions;
- Amounts used (i.e. incurred and charged against the provision) during the period; and
- Unused amounts reversed during the period.

An enterprise should disclose for each class of provision:

(a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

b) An indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, and

(c) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Note: SMCs are exempt from the above disclosure requirements.

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

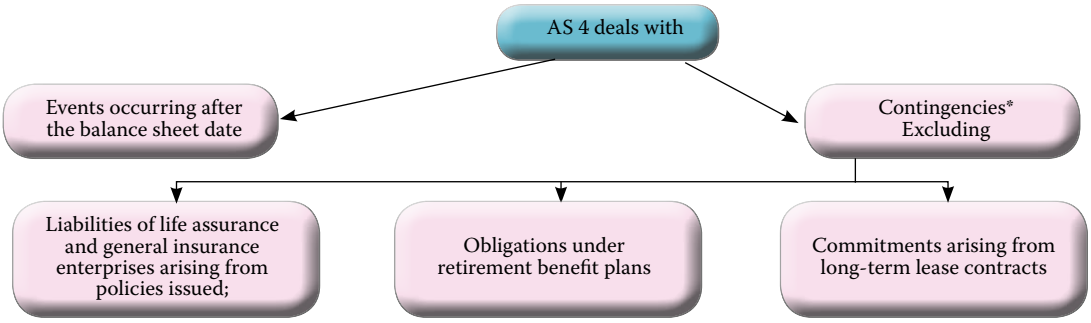
(a) An estimate of its financial effect,
(b) An indication of the uncertainties relating to any outflow; and
(c) The possibility of any reimbursement.

Where any of the information required by the standard is not disclosed because it is not practicable to do so, that fact should be stated.

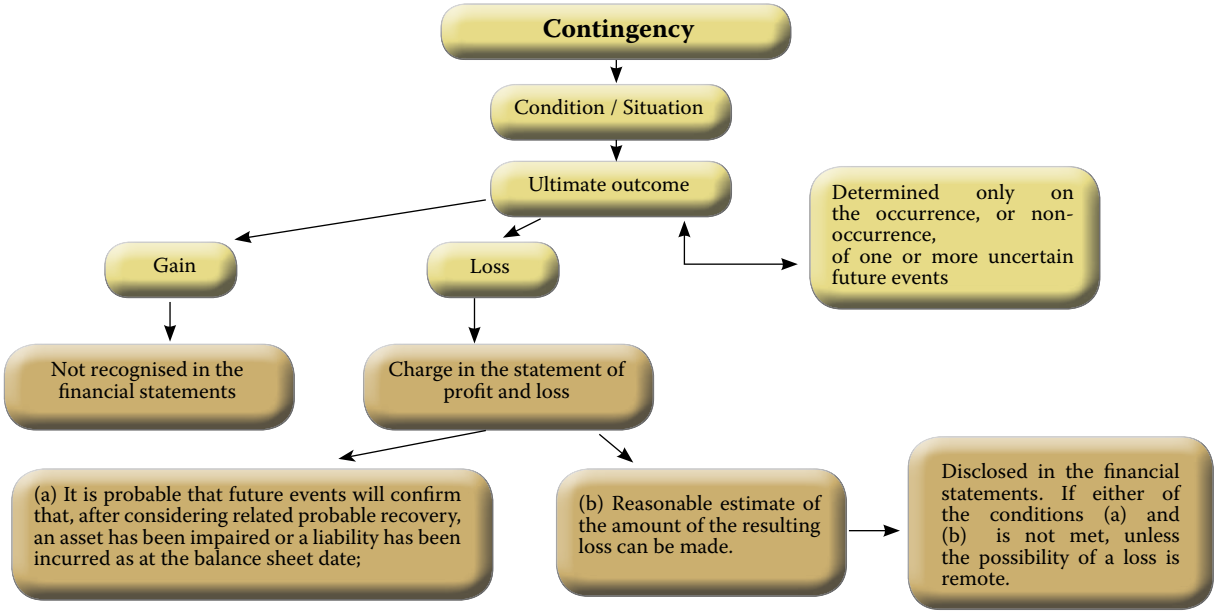
AS 4 "CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE"

Introduction

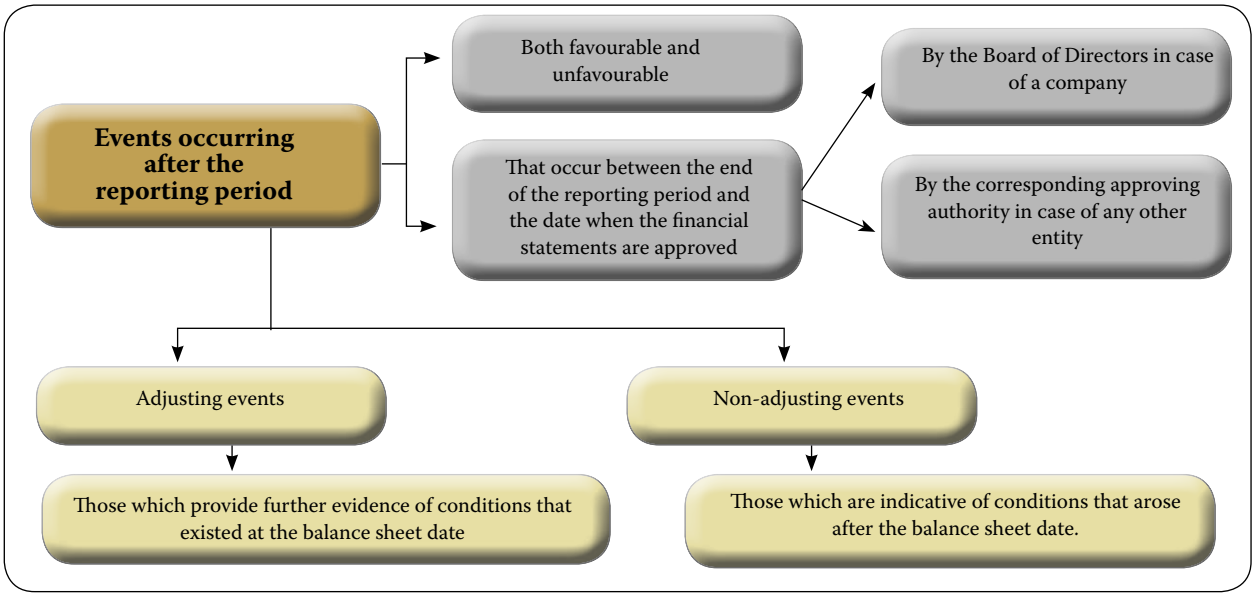
AS 4 defines contingencies and events occuring after the balance sheet date and describes the accounting treatment and disclosure requirements thereof.

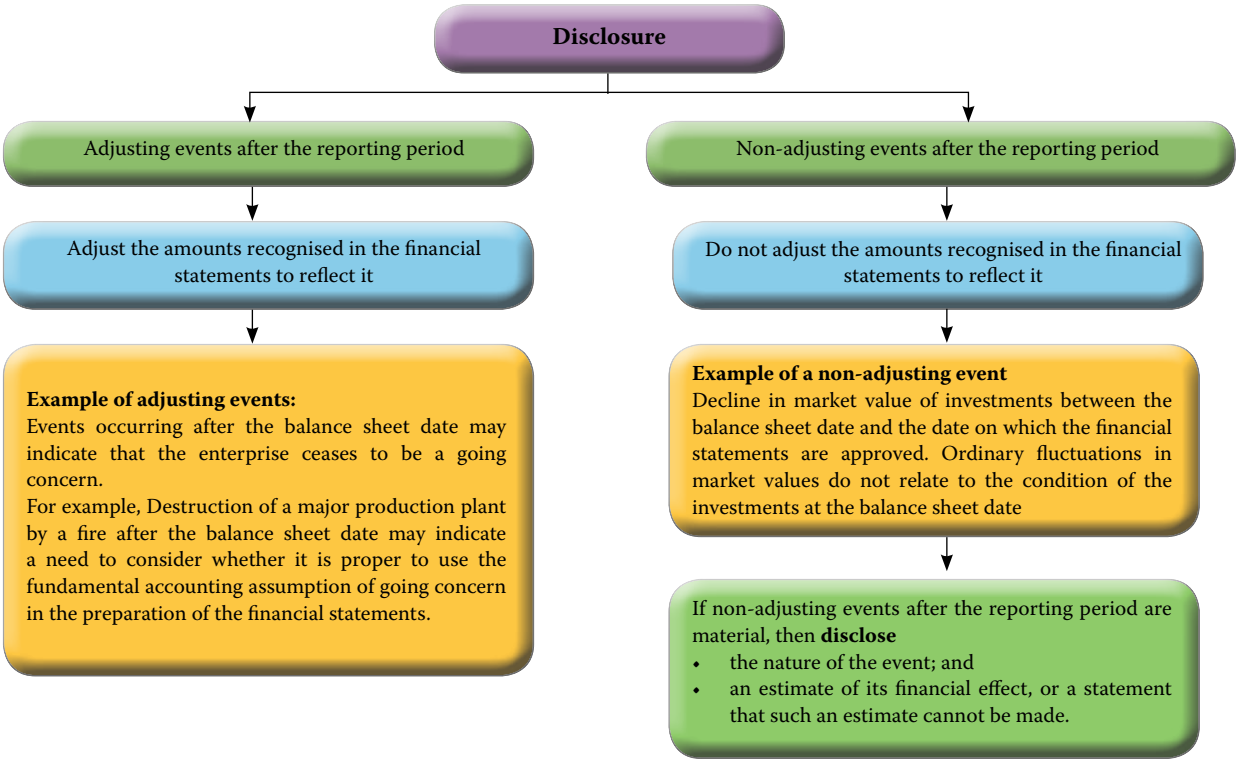


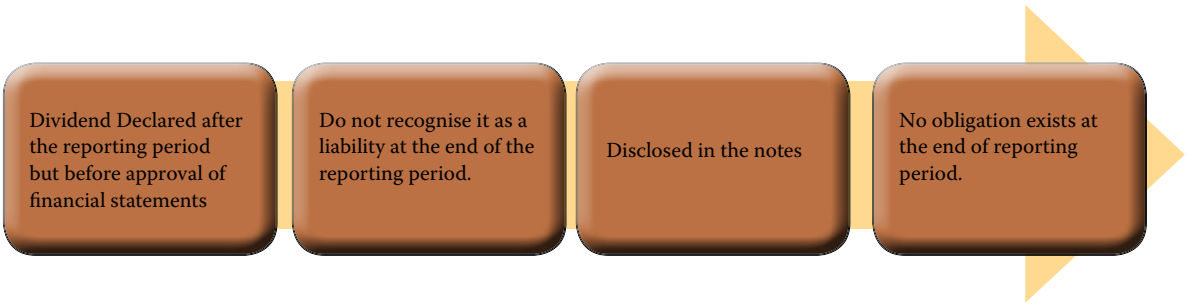
** All paragraphs of this Standard that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government.*



The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.


Events occurring after the reporting period
Both favourable and unfavourable
That occur between the end of the reporting period and the date when the financial statements are approved
By the Board of Directors in case of a company
By the corresponding approving authority in case of any other entity
Adjusting events
Non-adjusting events
Those which provide further evidence of conditions that existed at the balance sheet date
Those which are indicative of conditions that arose after the balance sheet date.


Disclosure
Adjusting events after the reporting period
Non-adjusting events after the reporting period
Adjust the amounts recognised in the financial statements to reflect it
Do not adjust the amounts recognised in the financial statements to reflect it
Example of adjusting events:
Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern.
For example, Destruction of a major production plant by a fire after the balance sheet date may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.
Example of a non-adjusting event
Decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not relate to the condition of the investments at the balance sheet date
If non-adjusting events after the reporting period are material, then disclose
• the nature of the event; and
• an estimate of its financial effect, or a statement that such an estimate cannot be made.


Dividend Declared after the reporting period but before approval of financial statements
Do not recognise it as a liability at the end of the reporting period.
Disclosed in the notes
No obligation exists at the end of reporting period.

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

Introduction

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

This Statement does not deal with tax implications of

- Extraordinary items,
- Prior period items,
- Changes in accounting estimates, and
- Changes in accounting policies for which appropriate adjustments are made.

Net Profit or Loss for the Period

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

Net Profit or Loss for the Period comprises

- Ordinary Items,
- Extra Ordinary Items,
- Prior Period Items,
- Changes in Accounting Estimates and
- Changes in Accounting Polices.

Profit or Loss from Ordinary Activities

Ordinary Activities

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.

Example

Profit/ Loss on sale of merchandise.

Disclosure

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 performance of entity, Nature and amount of such items should be disclosed separately.

Special disclousre

- Write-down of inventories to net realisable value as well as the reversal of such write-downs
- Restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring
- Disposals of items of fixed assets and long-term investments
- Legislative changes having retrospective application
- Litigation settlements and other reversals of provisions

Extraordinary Items

Extraordinary items

Income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly

Disclosed in the statement of profit and loss

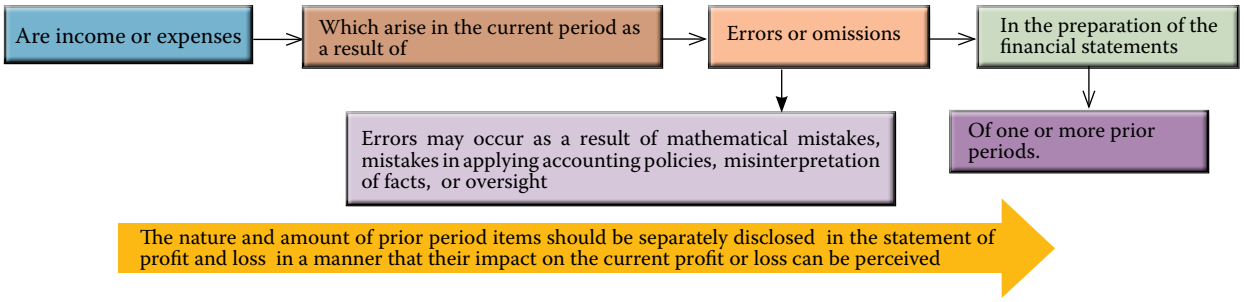
- As a part of net profit or loss for the period.
- Nature and amount of each item separately disclosed in a manner that its impact on current profit or loss can be perceived.

Examples

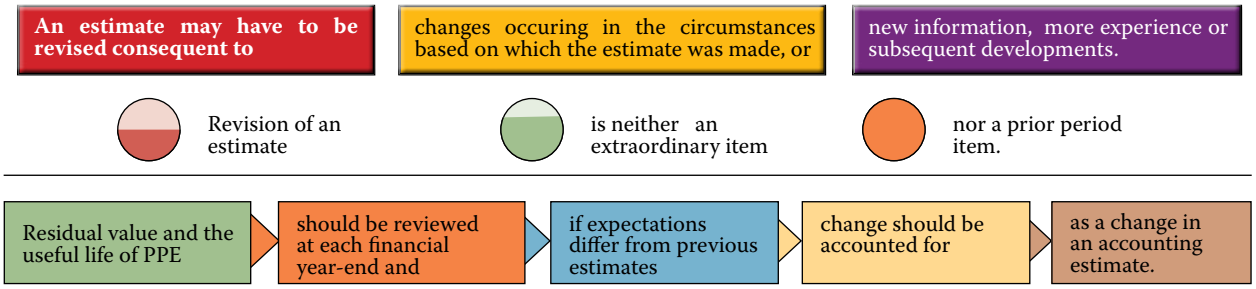
- Attachment of property of the enterprise
- An earthquake

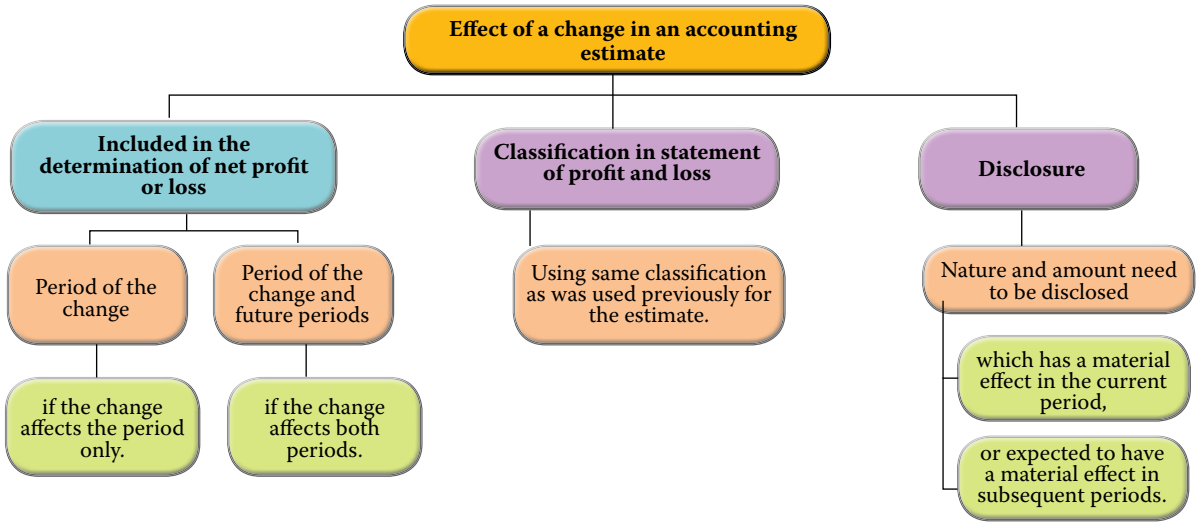
An event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities.

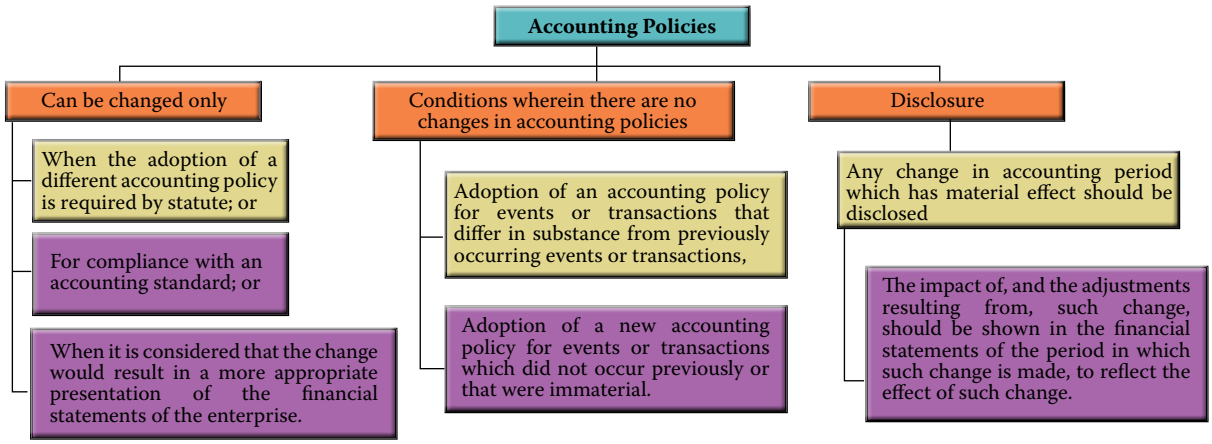
Prior Period Items



Changes in Accounting Estimates







CA INTERMEDIATE - PAPER 5 - ADVANCED ACCOUNTING

It has always been the endeavour of Board of Studies to provide quality academic inputs to the students. Considering this objective in mind, it has been decided to bring forth a crisp and concise capsule for Paper 5 'Advanced Accounting' at Intermediate level. The topics of Dissolution of partnership firms; Amalgamation of partnership firms; Conversion of partnership firm into a company and sale to a company; Issues related to accounting in Limited Liability and Accounting for ESOPs have been covered in this Capsule. The significant points of these topics have been presented through pictorial presentations in this capsule which will help the students in grasping the intricate practical aspects of each topic. This will facilitate the students to recapitulate the whole concepts within minimum time and efforts in the later stages of preparation. The capsule has been prepared keeping in view the new and revised scheme of Education and Training of ICAI, however the students of earlier scheme may also be benefitted from it. This capsule, though, facilitates the students in undergoing quick revision, under no circumstances, such revisions can substitute the detailed study of the material provided by the Board of Studies.

Chapter 2: Partnership Accounts

Dissolution of Partnership Firms

First of all, it is required to comprehend the circumstances leading to the dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also, the special adjustments relating to the insolvency of partners and the settlement of the partnership's liabilities must be thoroughly understood.

Let us understand the difference between Dissolution of Partnership and Dissolution of Partnership Firm.

Distinction between Dissolution of Partnership and Dissolution of Partnership Firm

Dissolution of Partnership	Dissolution of Partnership Firm
Dissolution of a partnership refers to the discontinuance of the relation between the partners of the firm.	Dissolution of the firm implies that the entire firm ceases to exist, including the relation among all the partners.
There can be change in profit sharing ratio or admission/ death/retirement of a partner.	Dissolution of partnership firm occurs.
In event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.	In event of the dissolution of the firm, the business ceases to end.
There is no intervention by the court.	Court has the inherent power to intervene. By its order, a firm can be dissolved.
Economic relationships among partners may remain same or change.	Economic relationship among partners comes to an end.
Assets and liabilities are revalued.	Assets are realized and liabilities are paid off.
Revaluation account is prepared.	Realization account is prepared.
Assets and liabilities are revalued after winding up of the existing partnership.	Assets and liabilities are settled on winding up of a firm.
Books of accounts are not closed.	Books of accounts are closed.

Circumstances Leading to Dissolution of Partnership

A partnership dissolves or comes to an end on:

- The expiry of the term for which it was formed
- Completion of the venture for which it was entered into
- Death of a partner
- Insolvency of a partner

The partners or remaining partners (in case of death or insolvency of a partner) may continue to do the business. In such a case there will be a new partnership, but the firm will continue. When the business comes to an end then only it will be said that the firm has been dissolved.

A firm stands dissolved in the following cases:				
The partners agree that the firm should be dissolved	All partners except one become insolvent	The business becomes illegal	In case of partnership at will, a partner gives notice of dissolution	The court orders dissolution

The court has the option to order dissolution of a firm if	• A partner has become of unsound mind; • A partner suffers from permanent incapacity; • A partner is guilty of misconduct of the business; • A partner persistently disregards the partnership agreement; • A partner transfers his interest or share to a third party; • The business cannot be carried on except at a loss; and • It appears to be just and equitable.

Consequences of Dissolution

On the dissolution of a partnership, firstly, the assets of the firm, including goodwill, are realized;

Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners;

Afterwards, the capital contributed by partners is repaid and, if there is still a surplus, it is distributed among the partners in their profit-sharing ratio.

Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm leftover are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio.

According to the provisions contained in the Partnership Act, upon dissolution of the partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:

The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order:

- in paying the debts of the firm to third parties
- in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital
- in paying to each partner what is due to him on account of capital
- the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits

Losses including deficiencies of capital are paid, first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.

Dissolution before the expiry of a fixed term

A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund of premium or of such part as may be reasonable, if the firm is dissolved before the term has expired.

The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of the period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit- sharing ratio.

No claim in this respect will arise if

- Firm is dissolved due to the death of a partner;
- Dissolution is mainly due to the partner's (claiming refund) own misconduct;
- Dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

Closing of Partnership Books on Dissolution

To close books of accounts of Partnership Firm, we need to transfer all the assets and liabilities to Realization Account. Given below is the specimen of the Realization Account.

Specimen of Realization Account

Particulars	₹	Particulars	₹
To Sundry Assets (Excluding Cash/Bank, Debit Balance of P&L A/c, Partners' Capital, and Loan A/cs)		By Sundry Liabilities (Excluding Credit Balance of P&L A/c, Partners' Capital, and Loan A/c)	
To Bank/Cash (expenses for realization)		By Provision on Assets	
To Bank/Cash A/c (Amount paid for liabilities and unrecorded liabilities)		By Bank/Cash A/c (Amount realized from assets and unrecorded assets)	
To Partners' Capital A/cs (Expenses or Liabilities paid by partners)		By Partners' Capital A/cs (Assets taken over by partners)	
To Partners' Capital A/cs (Profit on realization distributed among partners in profit sharing ratio)		By Partners' Capital A/cs (Loss on realization distributed among partners in profit sharing ratio)	

Points to Note

- If any of the assets are taken over by a partner at a value mutually agreed to by the partners, debit the Partner's Capital Account and credit Realization Account with the price of asset taken over.
- Pay off the liabilities (if not transferred to Realization A/c) crediting cash, and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realization Account.
- Liabilities to outsiders may also be transferred to the Realization Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realization Account, Cash Account being credited. If liability is taken over by a partner, Realization Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.
- The balance of the Realization Account will represent either the profit or loss on realization. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realization Account and debit various Partners' Capital Accounts; follow the opposite course in the case of a profit.
- Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.
- The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash, and debit the partners' capital account with the amount payable to them to close their accounts.

Consequences of Insolvency of a Partner

If a partner goes insolvent, the following are the consequences:

- The partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made
- The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary
- The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication
- The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication

Loss Arising from Insolvency of a Partner

When a partner is unable to pay his debt due to the firm, he is said to be insolvent and the share of loss is to be borne by other solvent partners following the decision in the English case of Garner vs. Murray.

According to this decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit-sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

The provisions of the Indian Partnership Act are not contrary to Garner vs. Murray rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per the deed should be applied.

Determination of Capital Ratio on Insolvency

- The partners are free to have either fixed or fluctuating capitals in the firm.
- If the partners are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, etc. are done through Current Accounts, which may have debit or credit balances, and insolvency loss is distributed in the ratio of fixed capitals.
- If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear the loss on account of the insolvency of other partner.
- If capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and drawings to the date of dissolution but before adjusting profit or loss on Realization.

Insolvency of all Partners

- When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances, it is better not to transfer the amount of creditors to Realization Account.
- The balance of the creditors' accounts is transferred to Deficiency Account. Creditors may be paid the amount available including the amount contributed by the partners.
- The unsatisfied portion of the creditor account is transferred to the Capital Accounts of the partners in the profit-sharing ratio. Then Capital Accounts are closed.

Piecemeal Payments

- Generally, the assets sold upon dissolution of partnership are realised only in small instalments over a period of time.
- In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted.
- In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order of payments.

Piecemeal distribution involves either of two methods

- Maximum Loss Method
- Highest Relative Capital Method

Maximum Loss Method

- Each installment realised is considered to be the final payment i.e., outstanding assets and claims are considered worthless and partners' accounts are adjusted on that basis each time when a distribution is made, following either Garner vs. Murray Rule or the profit-sharing ratio.

Highest Relative Capital Method

- According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off.
- For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals*.

*The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

Limited Liability Partnerships

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships.

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines **"limited liability partnership"** means a partnership formed and registered under this Act and **"limited liability partnership agreement"** means any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership.

Nature of Limited Liability Partnership

A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.

A limited liability partnership should have perpetual succession.

Any change in the partners of a limited liability partnership should not affect the existence, rights or liabilities of the limited liability partnership.

Non-applicability of the Indian Partnership Act, 1932 { Provisions of the Indian Partnership Act, 1932 should not apply to a limited liability partnership.

Distinction between an ordinary partnership firm and an LLP

	Key Elements	Partnerships	LLPs
1	Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
2	Registration	Optional	Compulsory with ROC
3	Creation	Created by an Agreement	Created by Law
4	Body Corporate	No	Yes
5	Separate Legal Entity	No	Yes
6	Perpetual Succession	Partnerships do not have perpetual succession	It has perpetual succession and individual partners may come and go
7	Number of Partners	Minimum 2 and Maximum 50	Minimum 2 but no maximum limit
8	Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm	The LLP as an independent entity can own assets
9	Liability of Partners / Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.
10	Principal Agent Relationship	Partners are the agents of the firm and of each other	Partners are agents of the firm only and not of other partners

Amalgamation, Conversion and Sale of Partnership Firms

Amalgamation of partnership firms includes

- Closing the old books of Amalgamating firms
- Opening the new books of Amalgamated firm

Amalgamation of Partnership Firms

When two or more partnership firms are amalgamated, the books of the old firm are closed and books of the new firm are opened. The accounting procedures for the same are:

Closing the books of old firm	Opening the books of the new firm
• Each firm should prepare a Realisation or Revaluation Account relating to its own assets and liabilities and transfer the balance to the partners' capital accounts in the profit-sharing ratio. • Entries for raising goodwill should be passed. • Assets and liabilities not taken over by the new firm should be transferred to the capital accounts of partners in the ratio of their capitals. • The new firm should be debited with the difference between the value of assets and liabilities taken over by it; the assets should be credited and liabilities debited. • Partners' capital accounts should be transferred to the new firm's account.	• Debit assets taken out at the agreed values. • Credit the liabilities taken over, and • Credit individual partners' capital accounts with the closing balances in the erstwhile firm. • When one firm is merged with another existing firm, entries will be in the pattern of winding up in the books of the firm which has ceased to exist. The other firm will record the transaction as that of a business purchase.

Conversion of Partnership Firm into a Company on sale to a Company

- At times partnerships also are reconstructed like joint-stock companies or are sold to companies.
- Reconstruction usually entails preparation of Reconstruction Account for determining the past losses which belong to old partners and writing them off to the debit of their capital accounts. If a creditor agrees to join as a partner the whole or only a part of the account standing to the credit of his loan account is transferred to his capital account.
- When the partnership firm is converted into a company, then the financial statements of the new company will be prepared according to Schedule III to the Companies Act, 2013.

Chapter 3: Accounting for ESOPs

In this chapter, the students are expected to learn the provisions of the Companies Act 2013 regarding employees' stock options and familiarize with the Guidance Note on Employee Share-Based Payments. They are also required to understand the accounting policies of employees' stock option plans and learn the accounting treatment of employees' stock options.

Employees stock option plan (ESOP)

ESOP is a plan under which the Company grants employees stock option. Employee Stock Option is a contract that gives the employees of the Company the right, but not the obligation, for a specified period of time to purchase or subscribe to the shares of the Company at a fixed determinable price.

ESOPs: Grant of options → Vesting of options → Exercise of options → Allotment of shares

As per the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

Important terms:

Grant:

Grant means issue of option to the employees under ESOP.

Vest:

Vest is to become entitled to receive cash or shares on satisfaction of any specified vesting conditions under an employee share-based payment plan.

Vesting Conditions:

These are the conditions that must be satisfied for the employee to become entitled to receive cash or shares pursuant to an employee share-based payment plan.

Vesting:

It is the process
by which the employee is given the right
to apply for shares of the company
against the option granted to him
in pursuance of employee stock option scheme.

Vesting Period:

It is the time period between grant date and
the date on which all the specified vesting conditions
of an employee share-based payment plan is to be satisfied.

Option:

Option means a right but not an obligation granted to an employee for a specified period of time to purchase or subscribe to the shares of the company at a pre-determined price.

Exercise:

It means making of an application by the employee to the enterprise for issue of shares against the option vested in him/her in pursuance of the Employee Stock Option Plan.

Exercise Period:

It is the time period
after vesting
within which the employee should exercise his right
to apply for shares against the options vested.

Exercise Price:

It is the price
payable by the employee
for exercising the option granted to him
in pursuance of ESOP.

Expected Life of an Option:

It is the period of time
from grant date
to the date
on which an option is expected to be exercised.

Grant Date:

It is the date
- at which the enterprise and
- its employees
- agree to the terms of an employee share-based payment plan.

At grant date, the enterprise confers on the employees the right to cash or shares of the enterprise, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process, (for example, by shareholders), grant date is the date when that approval is obtained.

Intrinsic Value:

It is the excess of

the market price of the share

under stock option plan

over the exercise price of the option.

Fair Value:

It is the amount → for which stock option granted or → a share offered for purchase could be → exchanged between → knowledgeable, willing parties in an arm's length transaction.

Provisions of Guidance Note on Employee Share-Based Payments

The Guidance Note on Accounting for Employee Share-Based Payments establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

As per the requirements of the Guidance Note on Employee Share-Based Payments, the enterprise should recognize an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest.

Types of Employee Share-Based Payment Plan

- Employee Stock Option Plan (ESOP)
- Employee Stock Purchase Plan (ESPP)
- Stock Appreciation Right (SAR)

For accounting purposes, employee share-based payment plans are classified into the following categories:

- **Equity-settled**
  - Under these plans, the employees receive shares.
- **Cash-settled**
  - Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- **Employee share-based payment plans with cash alternatives**
  - Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

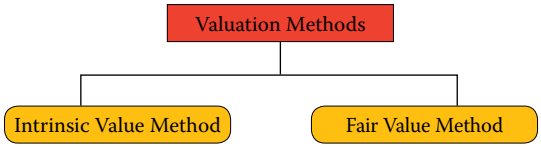
An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices, if available, considering the terms and conditions upon which those shares or stock options were granted. If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price.

Accounting Procedure

Equity-settled Employee Share-based Payment Plans	• An enterprise should recognize as an expense the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in the Guidance Note. • If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognize services received in full with a corresponding credit to the equity account. • If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account. • To apply the requirements of the Guidance, Note on Employee Share Based Payments, the enterprise should recognize an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. On exercise of right to obtain shares or stock options, the shares are issued on receipt of exercise price. • In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.
Cash-settled Employee Share-based Payment Plans	• For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognized in profit or loss for the period.
Employee Share-based Payment Plans with cash alternatives	• For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred. • Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. • Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. • In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer.

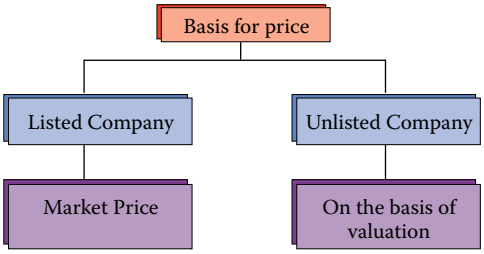
Valuation method – ESOPs

There are two methods of Accounting for Employee Share-Based Payments viz. Intrinsic Value method or Fair Value method.



ESOPs – Pricing criteria

Pricing of options in listed and unlisted companies is as follows:



Other significant aspects of Guidance Note

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc

Performance Conditions

There might be performance conditions that must be satisfied, such as the enterprise achieving a specified growth in profit or a specified increase in the share price of the enterprise. Thus, if an employee is granted stock options conditional upon the achievement of a performance condition and remaining in the employment of the enterprise until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the enterprise should presume that the services to be rendered by the employee as consideration for the stock options will be received in the future, over the expected vesting period.

The enterprise should estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a market condition, the estimate of the length of the expected vesting period should be consistent with the assumptions used in estimating the fair value of the options granted and should not be subsequently revised.

If the performance condition is not a market condition, the enterprise should revise its estimate of the length of the vesting period considering the subsequent information.

Cancellation of shares or stock options

If the enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

The enterprise should account for the cancellation or settlement as an acceleration of vesting and should therefore recognize immediately the amount that otherwise would have been recognized for services received over the remaining vesting period.

Any payment made to the employee on the cancellation or settlement of the grant should be deducted from the relevant equity account (e.g., Stock Options Outstanding Account) except to the extent that the payment exceeds the fair value of the shares or stock options granted, measured at the cancellation/settlement date. Any such excess should be recognized as an expense.

If new shares or stock options are granted to the employee as replacement for the cancelled shares or stock options, the enterprise should account for the granting of replacement shares or stock options in the same way as a modification of the original grant of shares or stock options.

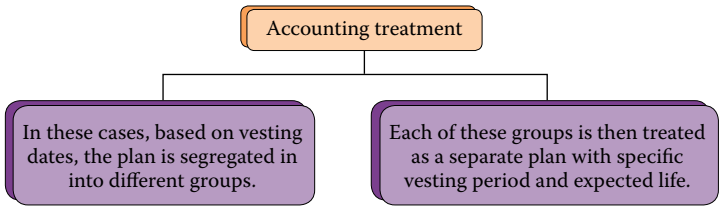
Accounting treatment in case of variation in Vesting Period

- Initial estimate of vesting period on grant date should be reviewed and revised if necessary, at the end of each accounting period.
- In case of revision of vesting period, the basis of allocation of option value to a particular accounting period should be based on revised estimate of vesting period.

Where the vesting condition is a market condition, e.g. when an option is granted subject to condition that the market price of the share reaches a specified level, the fair value of option is reduced due to the possibility that the vesting condition may not be satisfied. Such fair values are recognised as expense whether or not the market condition is satisfied, over the vesting period estimated on grant date. The estimates of vesting periods are not revised subsequently in these cases.

Graded Vesting

Graded vesting refers to a situation where options under a plan vest on different dates.



- An enterprise should make a policy decision as to which accounting treatment to be followed in respect of graded vesting.
- Since one of the factors affecting fair value of an option is expected life, the fair value for each group should be computed separately. Fair value of a group is then allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.
- Intrinsic value of an option does not depend on its expected life. Intrinsic value of option per share shall therefore be same for each group. In the same way as fair value, intrinsic value of a group is allocated to accounting periods and recognised as expense for the period with reference to vesting period.

CA INTERMEDIATE - PAPER 5 - ADVANCED ACCOUNTING

In a pursuit to provide quality academic inputs to the students to help them in grasping the intricate aspects of the subject, Board of Studies bring forth a crisp and concise capsule on Paper 5 'Advanced Accounting' at Intermediate level. The significant points of the topics of Buy-back of Securities and Equity shares with differential rights; Amalgamation of companies and Accounting for reconstruction of companies have been covered in this Capsule through pictorial presentations. The capsule has been prepared keeping in view the new and revised scheme of Education and Training of ICAI, however the students of earlier scheme may also be benefitted from it. This capsule, though, facilitates the students in undergoing quick revision, under no circumstances, such revisions can substitute the detailed study of the material provided by the Board of Studies.

CHAPTER 4: BUYBACK OF SECURITIES AND EQUITY SHARES WITH DIFFERENTIAL RIGHTS

Buy-Back of Shares

Buy-back of shares means

- purchase of its own shares
- by a company

When shares are bought back by a company, they have to be cancelled by the company.

Thus, shares buy-back results in decrease in share capital of the company.

A company cannot buy its own shares for the purpose of investment.

A company having sufficient cash may decide to buy-back its own shares.

Objectives of buy-back of shares

(a) to increase earnings per share if there is no dilution in company's earnings as the buy-back of shares reduces the outstanding number of shares.

(b) to increase promoters holding as the shares which are bought back are cancelled.

(c) to discourage others to make hostile bid to take over the company as the buy-back will increase the promoters holding.

(d) to support the share price on the stock exchanges when the share price, in the opinion of company management, is less than its worth, especially in the depressed market.

(e) to pay surplus cash to shareholders when the company does not need it for business.

The Companies Act, 2013 permits companies to buy-back their own shares and other specified securities out of:
(i) its free reserves; or
(ii) the securities premium account; or
(iii) the proceeds of the issue of any shares or other specified securities.

Note: No buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

Important provisions of the Companies Act relating to the buy-back are:

(1) No company shall purchase its own shares or other specified securities unless—

(a) the buy-back is authorised by its articles;

(b) a special resolution has been passed in general meeting of the company authorising the buy-back;
However, the above provisions do not apply where the buy-back is ten percent or less of the paid-up equity capital + free reserves and is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy-back is up to 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of its being authorized by the articles of association of the company and by a special resolution of its members passed at a general meeting of the company.

(c) the buy-back must be equal or less than twenty-five per cent of the total paid-up capital and free reserves of the company; (Resource Test)

(d) further, the buy-back of shares in any financial year must not exceed 25% of its total paid-up capital and free reserves; (Share Outstanding Test)

(e) the ratio of the debt owed by the company (both secured and unsecured) after such buy-back is not more than twice the total of its paid-up capital and its free reserves; (Debt-Equity Ratio Test)
Note: Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies. Debt here should include both long-term debt as well as short term debt.

(f) all the shares or other specified securities for buy-back are fully paid-up;

(g) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

(h) the buy-back in respect of shares or other specified securities is in accordance with the guidelines as may be prescribed.

Provided that no offer of the buy-back under this sub section shall be made within a period of one year reckoned from the date of closure of a previous offer of buy-back if any.

(2) Every buy-back shall be completed within twelve months from the date of passing the special resolution, or the resolution passed by the board of directors.

(3) The buy-back may be—

(a) from the existing security holders on a proportionate basis; or

(b) from the open market; or

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(4) Where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.

(5) The shares or other specified securities which are proposed to be bought-back must be fully paid-up.

(6) The Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

(7) Premium (excess of buy-back price over the par value) paid on buy-back should be adjusted against free reserves and/or securities premium account. Revaluation reserve represents unrealized profit and hence it cannot be used for buy-back of securities.

(8) No company shall directly or indirectly purchase its own shares or other specified securities—

(a) through any subsidiary company including its own subsidiary companies; or

(b) through any investment company or group of investment companies; or

(c) if a default is subsisting, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon*.

Definitions

(a) Specified Securities

"specified securities" includes

employees' stock option or

other securities as may be notified by the Central Government from time to time

(b) Free Reserves

"Free reserves*" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:		
Provided that-	(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or	(ii) any change in carrying amount of an asset or a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

Issue of Equity Shares with Differential Rights

- As per the Companies Act 2013, companies can issue equity shares with differential rights subject to the fulfilment of certain conditions. Companies (Share Capital and Debentures) Rules, deals with equity shares with differential rights.
- Differentiation can be done by giving a superior dividend / Superior voting right / diluted voting right to a class of equity shareholders.

Share capital is of two types – equity and preference. Preference share capital with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to

(i) Payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and

(ii) Repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

The Companies Act, 2013 defines equity share capital to include two types viz.,

(i) With voting rights; or

(ii) With differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed

Voting Rights

Companies Act defines "voting right," as the right of a member of a company to vote in any meeting of the company or by means of postal ballot.

Equity shares have a general voting right, whereas preference shares have restrictive voting rights.

According to the provisions of the Companies Act:

(i) Every member of a company limited by shares and holding equity share capital therein, shall have a right to vote on every resolution placed before the company; and	(ii) His voting right on a poll shall be in proportion to his share in the paid-up equity share capital of the company.

Normally preference shareholders have superior financial rights but less management control rights. Every member of a company limited by shares and holding any preference share capital therein shall, in respect of such capital, have a restrictive right to vote only on resolutions placed before the company:

a. Which directly affect the rights attached to his preference shares or	b. Any resolution for the winding up of the company or	c. For the repayment or	d. Reduction of its equity or preference share capital.

CHAPTER 5: AMALGAMATION OF COMPANIES

Amalgamation means an amalgamation pursuant to the provisions of the Companies Act 2013 or any other statute which may be applicable to companies and includes merger.

- Amalgamation refers to the process of merger of two or more companies into a single entity or where one company takes over the other by outright purchase.

The accounting for amalgamation depends on whether amalgamation is in the nature of merger or in the nature of purchase.

the term 'amalgamation' contemplates two kinds of activities: → two or more companies join to form a new company or → absorption and blending of one by the other.

The accounting for amalgamation depends on whether amalgamation is in the nature of merger or in the nature of purchase.

Types of Amalgamation
- Amalgamation in the nature of merger
- Amalgamation in the nature of purchase

In amalgamation we have generally two companies called as
- Vendor or Transferor Company
- Vendee or Transferee Company

The concept given above can be understood from the following table of differences-

Basis	Amalgamation	Absorption	External Reconstruction
Meaning	Two or more companies are wound up and a new company is formed to take over their business.	In this case an existing company takes over the business of one or more existing companies.	In this case, a newly formed company takes over the business of an existing company.
Number of new resultant companies	Only one resultant company is formed. Two companies are wound up to form a single resultant company.	No new resultant company is formed.	Only one resultant company is formed. Under this case a newly formed company takes over the business of an existing company.
Objective	Amalgamation is done to cut competition & reap the economies in large scale.	Absorption is done to cut competition & reap the economies in large scale.	External reconstruction is done to reorganize the financial structure of the company.

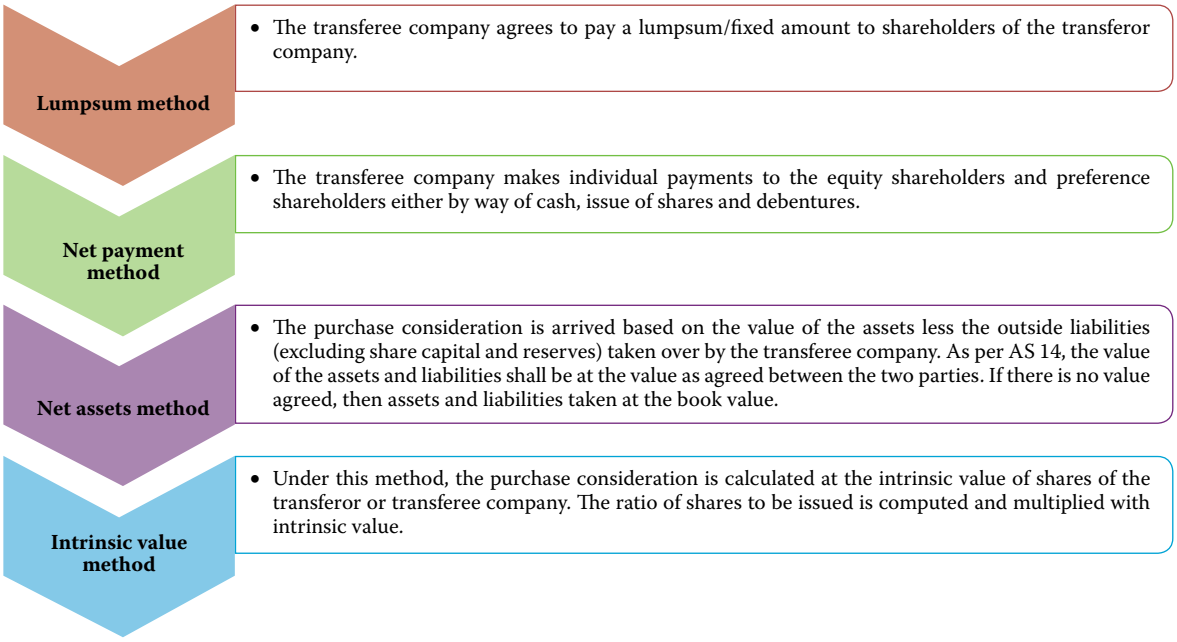
Purchase Consideration

AS 14 defines the term purchase consideration as the *"aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company"*.

In simple words, it is the price payable by the transferee company to the transferor company for taking over the business of the transferor company.

It is important to note that the amount paid towards the equity shareholders and preference shareholders is only considered as part of the purchase consideration as per the definition under AS-14. Hence, it should be noted that purchase consideration ***does not include*** the sum which the transferee company will directly pay to the debenture-holders or creditors of the transferor company. If a certain liability of the transferor company has not been taken over by the transferee company it will be discharged by the transferor company.

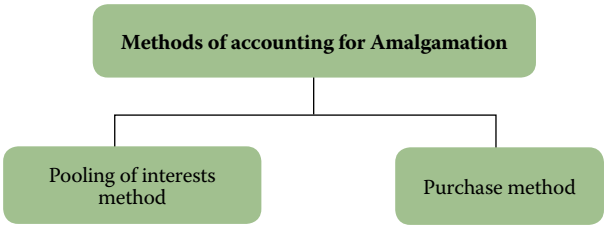
The purchase consideration can be computed in the following methods-



Any of the methods or a combination of the above methods can be used by the companies to calculate the purchase consideration.

Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamation viz,



The *first method* is used in case of a*malgamation in the nature of merger where the conditions as per AS-14, required are fulfilled* and the *second method* is used in case of a*malgamation in the nature of purchase.*

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

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

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

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

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

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

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

Pooling of Interest Method

In case of pooling method- the amount to be adjusted against the reserves- can be computed in the following 3 steps-

Purchase Method

Assets and Liabilities

- Assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

In case of purchase method- the amount to be transferred to capital reserve or to be recorded as Goodwill- can be computed as

Step I	Step II	Step III
Find out the **Net assets** amount using the following formula- Total assets- Outside liabilities (Non-current liabilities + Current Liabilities)	Compute the purchase consideration using any of the methods as given under Purchase consideration computation	If Step I- Step II= Positive amount- then it is capital reserve- since the assets received more than the amount paid as purchase consideration to acquire them. If Step I- Step II= Negative amount- then it is to be recorded as Goodwill (intangible asset) - since the amount paid for acquiring business is more than the net assets, which is technically due to its goodwill.

Treatment of reserves under purchase method-

No reserves, other than statutory reserves, of the transferor company should be incorporated in the financial statements of transferee-company.

The balance of Profit and Loss account, general reserves of the transferor company are not recorded at all.

1. Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made only in respect of statutory reserves and such reserves shall retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, till the time their identity is required to be maintained to comply with the relevant statute.

2. 'Amalgamation Adjustment Reserve' is debited to bring in the statutory reserves of the transferor company. This is represented as deduction from the reserves of the transferee company after amalgamation.

3. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. Statutory reserves of the transferor company should be incorporated in the balance sheet of transferee company by way of the following journal entry.

Amalgamation Adjustment Reserve A/c Dr.
To Statutory Reserves

4. Once after the time period to show such statutory reserves is over, both the reserves and the aforesaid account are reversed. **Amalgamation Adjustment Reserve'** has to be shown as a separate line item - which implies, that this debit "cannot be set off against statutory reserve taken over" and therefore, the presentation will be as follows

Reserves

Description	Amount (Current year)	Amount (Previous Year)
Statutory Reserve (taken over from transferor company)		
General Reserve		
Retained Earnings		
Amalgamation Adjustment Reserve (negative balance)	(--)	(--)

Journal Entries to close the books of Vendor Company

In case of amalgamation under any of the above methods, there shall be an accounting treatment both in the books of vendor (transferor) and vendee (transferee) companies.

Since the books of the vendor will be closed upon amalgamation- the assets and the liabilities at the book values are transferred to a separate account called as the "Realization account".

The purchase consideration receivable is credited to the Realization account. On the receipt of the purchase consideration, it is debited to equity shareholders and preference shareholders' account. The balance of realization account (either profit/loss) is transferred to the equity shareholders' account.

Those assets and liabilities which are not taken over by vendee company but settled by the vendor company are shown in the books of the vendor only.

1. Open Realization Account and transfer all assets at book value.

Exception: **If cash is not taken over by the purchasing company, it should not be transferred.**

Note: **Profit and Loss Account (Dr.) and expenses not written off are not assets and should not be transferred to the Realization Account.**

2. Transfer to the Realization Account the liabilities which the purchasing company is to take over.

In case of the provisions, the portion which represents liability expected to arise in future should be so transferred and the portion which is not required should be treated as profit.

For liabilities not taken over by the purchasing company, the profit or loss on discharge of such liabilities shall be transferred to Realization Account

3. Debit purchasing company and credit Realization Account with the purchase consideration.
4. On receipt of the purchase consideration debit what is received (cash, debentures, shares etc.) and credit the purchasing company.
5. Expenses of Liquidation-

Expenses of liquidation have to be dealt with according to the circumstances of each case.

- If vendor company has to bear and pay → Realization Account should be debited and Cash Account credited.
- If the expenses are to be borne by the purchasing company, the question may be dealt within one of the two ways mentioned as
  - It may be ignored in the books of the vendor company.
  - If the expenses are to be paid first by the vendor company and afterwards reimbursed by the purchasing company, the following two entries will be passed:
    - Debit Purchasing company and credit Cash Account when expenses are paid by the vendor company; **and**
    - Debit Cash Account and credit purchasing company (on the expenses being reimbursed).

6. Liabilities not assumed by the purchasing company, have to be paid off. On payment, debit the liability concerned and credit cash. Any difference between the amount actually paid and the book figure must be transferred to the Realization Account.
7. Credit the preference shareholders with the amount payable to them, debiting Preference Share Capital with the amount shown in the books, transferring the difference between the two, if any, to the Realization Account.

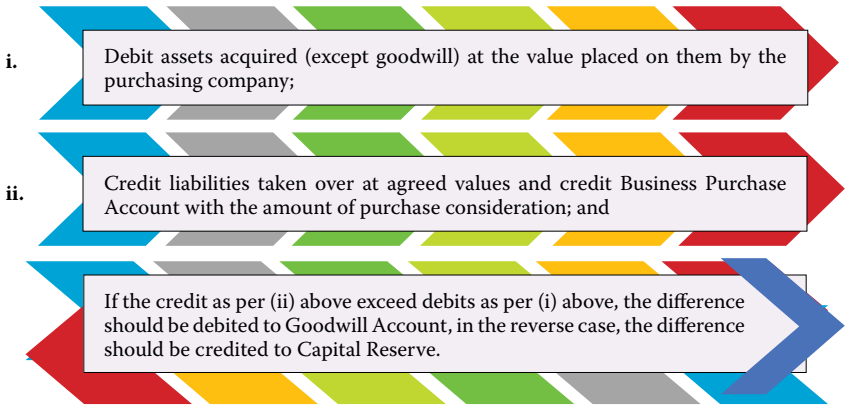
- In the absence of any indication to the contrary, preference shareholders will be entitled only to the capital contributed by them. But if funds available after paying off creditors are not sufficient to satisfy the claim of preference shareholders fully, they will have to suffer a loss to the extent of the deficit.

8. Pay off preference shareholders by debiting them and crediting whatever is given to them.
9. Transfer equity share capital and account representing profit or loss (including the balance in Realization Account) to Equity Shareholders Account. This will determine the amount receivable by the equity shareholders.
10. On satisfaction of the claims of the equity shareholders, debit their account and credit whatever is given to them.

Entries in the books of Purchasing Company

In the books of the purchasing/ vendee/ transferee company, the assets and liabilities which are taken overs are recorded at the agreed values and where there is no agreed value then at the book values.

1. Debit Business Purchase Account and Credit Liquidator of the vendor company with the account of the purchase consideration.
2.



3. On the payment to the vendor company the balance at its credit, the entry to be made for payment of cash and issue of shares in satisfaction of purchase consideration.
4. If the purchasing company is required to pay the expenses of liquidation of the vendor company, the amount should be debited to the Goodwill or Capital Reserve Account, as the case may be.

Typical adjustments which shall be noted while working out the problems-

Inter Company-owing	• If the purchasing company owe an amount to the vendor company or vice versa, the amount will be included in the book debts of one company and trade payables of the other. This should be adjusted by the entry: • Trade payables Dr. To Trade receivables • The entry should be made after the usual acquisition entries have been passed. At the time of preparing the Realization Account and passing the business purchase entries, no attention need be paid to the fact that the two companies involved owed money mutually.
Adjustment of the value of stock	• Inter-company owings arise usually from purchase and sale of goods; it is likely, therefore, that at the time, of the sale of business, the debtor company also has goods in stock which it purchased from the creditor company - the cost of the debtor company will include the profit made by the creditor company. After the takeover of the business it is essential that such a profit is eliminated. The entry for this will be made by the purchasing company. If it is the vendor company which has such goods in stock, at the time of passing the acquisition entries, the value of the stock should be reduced to its cost to the company which is acquiring the business; automatically goodwill or capital reserve, as the case may be, will be adjusted. But if the original sale was made by the vendor company and the stock is with the company acquiring the business, the latter company will have to debit Goodwill (or Capital Reserve) and credit stock with the amount of the profit included in the stock.
Inter-company Loans	• Where there is any loan taken by the transferor company from the transferee company then the amount of the loan shall be taken over by the transferee company and adjustment entry to be passed as follows- • Loan (liability of Transferor co) A/c Dr XXX To Loans and advances (assets) XXX

CHAPTER 6 INTERNAL RECONSTRUCTION

Meaning of Reconstruction

Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered, by reducing the paid-up value of shares and/or varying the rights attached to different classes of shares.

The object of reconstruction is usually to reorganize capital or to compound with creditors so that company can be bailed out from present situation without winding up the existing company.

Types of Reconstruction

- **Internal Reconstruction**
- **External reconstruction**

Difference Between Internal and External Reconstruction

Basis	Internal Reconstruction	External Reconstruction
Liquidation and formation of new company	The existing company is not liquidated rather the capital and debt structure is changed.	The existing company is liquidated to form a new company in which the existing shareholders become shareholders of new company as well.
Reduction of capital and varying rights	There is certain reduction of capital and sometimes the outside liabilities like debenture holders may have to reduce their claim in this scheme.	There is no reduction of capital. In fact, there may be addition of fresh share capital of the company. The shareholders need not vary their rights in company

Methods of Internal Reconstruction

For properly deploying the process of internal reconstruction, following methods are generally employed or used simultaneously:

Methods of Internal Reconstruction

- Alteration of Share Capital
  - Sub-division and Consolidation of Shares
  - Conversion of share into stock or vice-versa
- Variation of Shareholders' rights
- Reduction of Share Capital
- Compromise/ Arrangement
- Surrender of Shares

Alteration of Share Capital

According to the Companies Act 2013, a limited company can alter its share capital, if so authorized by its Articles, by passing a resolution in the general meeting.

Sub-division and Consolidation of Shares

The existing share capital can be sub-divided or consolidated into the shares into those of a smaller or higher denomination than that fixed by the Memorandum of Association, so long as the proportion between the paid up and unpaid amount, if any, on the shares continues to be the same as it was in the case of the original shares.

Conversion of Fully Paid Shares into Stock and Stock into Shares

According to the provisions of the Companies Act, 2013, a company can convert its fully paid shares into stock and reconversion of stock into shares. If authorized by its Articles, a company may, in a general meeting by passing an ordinary resolution, can convert its fully paid shares into stock and reconversion of stock into shares. Stock is the consolidation of the share capital into one unit divisible into parts.

A company can convert its fully paid shares into stock. Upon the company converting its shares into stock, the book-keeping entries merely record the transfer from share capital account to stock account.

Variation of Shareholders Rights

- The Companies Act, 2013 provides that when a company has issued different classes of shares with different rights or privileges attached to such shares e.g. rights as to dividend, voting rights etc., any of such right may be changed in any manner.

The company may

- Change rate of dividend on preference shares
- convert cumulative preference shares into non-cumulative preference shares

without changing the amount of share capital by passing the following journal entries:

(a)Debit (Old)% Cum. Pref. Share Capital Account
Credit (New)% Cum. Pref. Share Capital Account

(b)Debit ...% Cum. Pref. Share Capital Account
Credit ...% Non-cum. Pref. Share Capital Account

Reduction of Share Capital

The Companies Act, 2013 lays down the procedure in respect of reduction of share capital. Subject to confirmation by the Tribunal on an application by the company, a company may, by a resolution, reduce the share capital in the following manner-

- Extinguishing or reducing the liability of the shareholders in respect of unpaid amount on the shares held by them
- Paying off any paid-up share capital which is in excess of its requirements
- Cancelling any paid-up share capital which is lost or is unrepresented by available assets

Generally, reduction in share capital is followed when a company has been suffering losses continuously for a long time and capital is not truly represented by its assets. In such a case, any scheme for capital reduction should write-off that portion of capital which is already lost

This reduction is a sacrifice by the shareholders and the amount of reduction or sacrifice is credited to a new account called Capital Reduction Account (or Reconstruction Account). Reconstruction account is a new account opened to transfer the sacrifice made by the shareholders for that part of capital which is represented by lost assets.

The accounting treatment is as follows:

(a) When liability of the shareholders is extinguished or reduced in respect of unpaid amount on the shares held by them:

Here the shareholders are not called upon to pay the unpaid amount on shares held by them in future. For example, a company decides to reduce ₹ 10 per share, into ₹ 7.5 per share fully paid up, by cancelling the unpaid amount of ₹ 2.5 per share.

(b) When excess paid up capital is paid off:

When it is not possible for the company to employ profitably its paid up capital, then in such case it may decide to refund the excess capital to its shareholders. For example, a company having fully paid-up share of ₹ 10 each, decides to pay-off ₹ 2 per share to make it of ₹ 8 fully paid-up.

(c) When the paid up capital which is lost or not represented is cancelled:

Reduction in paid up value only- Here the nominal value of the share remains the same and only the paid value is reduced. For example, the shareholders may agree to reduce the paid capital of ₹ 100 per share to paid value of ₹ 10 per share.

Reduction in both nominal and paid up values- In this case, both the paid up capital and nominal value of the shares are reduced.

Compromise/Arrangement

A scheme of compromise and arrangement is an agreement between a company and its members and outside liabilities when the company faces financial problems. Such an arrangement therefore also involves sacrifices by shareholders, or creditors or debenture holders or by all of them.

Accounting treatment for some of the cases is as follows:

When equity shareholders give up their right over the reserves and accumulated profits of the company: Reserves Account Dr. (With the amount of reserves) To Reconstruction Account	**Settlement of outside liabilities at lesser amount:** Liabilities such as sundry creditors may agree to accept less amount in lieu of final settlement. Treatment will be as follows: Outside Liabilities Account Dr. (With the amount of sacrifice) Provision Account (if any) Dr. To Reconstruction Account

Surrender of Shares

In this, shares are divided into shares of smaller denominations and then the shareholders are made to surrender their shares to the company. These shares are then allotted to debenture holders and creditors so that their liabilities are reduced. The unutilized surrendered shares are then cancelled by transferring them to Reconstruction Account.

Entries in case of internal reconstruction

On a scheme of internal reconstruction being adopted the accounting treatment of the different situations and the entries to be passed are as follows:

- Alteration of share capital and varying of the shareholders rights do not involve the capital reduction/reconstruction account.
- Under reduction of share capital, unrepresented reserves, compromise/ arrangements with the outsiders liabilities and surrender of shares, there shall be capital reduction/reconstruction account used to which the unrepresented assets/liabilities will be transferred as per the arrangement.
- An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the account concerned and credited to Capital Reduction Account (or Reconstruction Account).
- Eliminate debit balance of profit and loss account and over-valuation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account, it should be transferred to the Capital Reserve Account.

While preparing the balance sheet of a reconstructed company, the points to be kept in mind:

(a) After the name of the company, the words **"and Reduced"** should be added only if the Court so orders.

b) In case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.