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Accounting Standards

Unit 1 : Introduction to Accounting Standards

Learning objectives

After studying this unit you will be able to:

- ◆ Understand the concept of Accounting Standards.
- ◆ Grasp the objectives, benefits and limitations of Accounting Standards.
- ◆ Learn the standards setting process.
- ◆ Familiarize with the overview of Accounting Standards in India.
- ◆ Recognize the International Accounting Standard Authorities.
- ◆ Appreciate the adoption of International Financial Reporting Standards as global standards.

1.1 Introduction

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.

Accounting Standards deal with the issues of

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

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- (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

Accounting Standards standardize diverse accounting policies with a view to

- (i) Eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements, to the maximum possible extent, and
- (ii) Provide a set of standard accounting policies, valuation norms and disclosure requirements.

The standard policies are intended to reflect a consensus on accounting policies to be used in different identified area, e.g. inventory valuation, capitalisation of costs, depreciations and amortisations etc. Since it is not possible to prescribe a single set of policies in any area to be appropriate for all enterprises for all time, it is not enough to comply with the standards and state that they have been followed; one must also disclose the accounting policies actually used in preparation of financial statements. (See AS 1, Disclosure of Accounting Policies given in Appendix I of this Module). For example, an enterprise should disclose which of the permitted cost formula (FIFO, Weighted Average etc.) has actually been used for ascertaining inventory costs.

In addition to improving credibility of accounting data, standardisation of accounting procedures improves comparability of financial statements, both intra-enterprise and inter-enterprise. Such comparisons are very effective and most widely used tools for assessment of enterprise performances by users of financial statements for taking economic decisions, e.g. whether or not to invest, whether or not to lend and so on.

The intra-enterprise comparison involves comparison of financial statements of same enterprise over number of years. The intra-enterprise comparison is possible if the enterprise uses same accounting policies every year in drawing up its financial statements. For this reason, AS 1 requires disclosure of changes in accounting policies.

The inter-enterprise comparison involves comparison of financial statements of different enterprises for same accounting period. This is possible only when comparable enterprises use same accounting policies in preparation of respective financial statements. The disclosure of accounting policies allows a user to make appropriate adjustments while comparing the financial statements.

Another advantage of standardisation is reduction of scope for *creative accounting*. The creative accounting refers to twisting of accounting policies to produce financial statements favourable to a particular interest group. For example, it is possible to overstate profits and assets by capitalising revenue expenditure or to understate them by writing off a capital expenditure against revenue of current accounting period. Such practices can be curbed only by framing rules for capitalisation, particularly for the borderline cases where it is possible to have divergent views. The accounting standards do just that.

In brief, the accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks.

1.2 Standards Setting Process

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes, representatives of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards and Council of the ICAI is not empowered to make any modifications in the draft accounting standards formulated by ASB without consulting with the ASB.

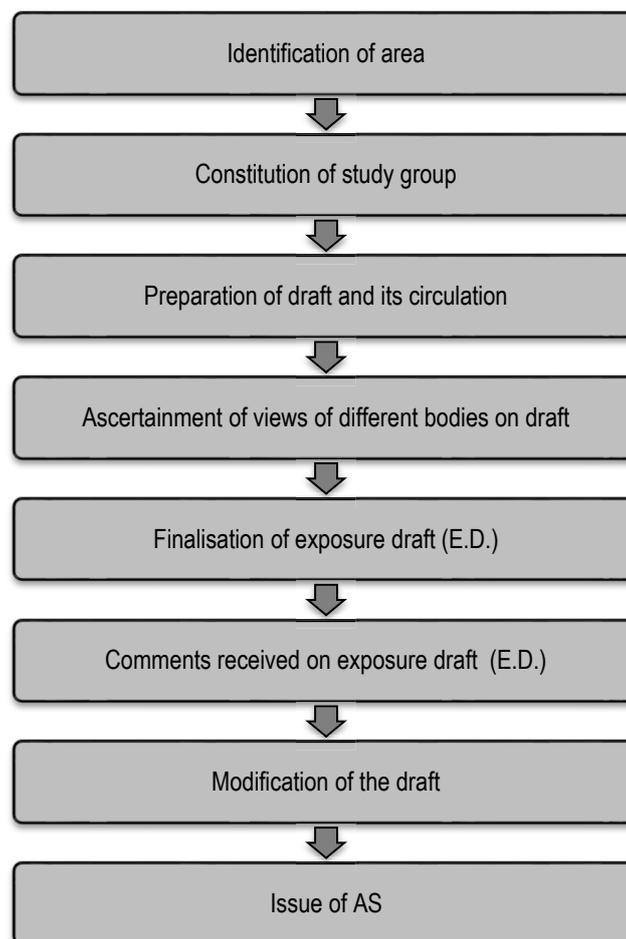
The standard-setting procedure of Accounting Standards Board (ASB) can be briefly outlined as follows:

- ◆ Identification of broad areas by ASB for formulation of AS.
- ◆ Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.
- ◆ Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- ◆ Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- ◆ Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- ◆ Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.

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- ◆ Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- ◆ Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
- ◆ The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For corporate entities, the accounting standards are issued by The Central Government of India.

Standard – Setting Process



Earlier, ASB used to issue Accounting Standard Interpretations which address questions that arise in course of application of standard. These were, therefore, issued after issuance of the relevant standard. Authority of the accounting standard interpretation (ASIs) was same as

that of the accounting standard (AS) to which it relates. However, after notification of accounting standards by the Central government for the companies, where the consensus portion of ASI was merged as 'Explanation' to the relevant paragraph of the accounting standard, the council of ICAI also decided to merge the consensus portion of ASI as 'Explanation' to the relevant paragraph of the accounting standard issued by them. This initiative was taken by the council of the ICAI to harmonise both the set of standards i.e. accounting standards issued by the ICAI and accounting standards notified by the central government.

It may be noted that as per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Advisory Committee on Accounting Standards (NACAS).

1.3 Benefits and Limitations

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

- (i) **Standardisation of alternative accounting treatments:** Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) **Requirements for additional disclosures:** There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.
- (iii) **Comparability of financial statements:** The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

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

- (i) **Difficulties in making choice between different treatments:** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) **Lack of flexibilities:** There may be a trend towards rigidity and away from flexibility in applying the accounting standards.

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- (iii) **Restricted scope:** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

1.4 How many Accounting Standards?

The Council of the Institute of Chartered Accountants of India has, so far, issued **twenty nine Accounting Standards**. However, AS 6 on 'Depreciation Accounting' has been withdrawn on revision of AS 10 'Property, Plant and Equipment*' and AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are now only 27 notified accounting standards as per the Companies (Accounting Standards) Rules, 2006 (as amended in 2016).

The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.5 Need for Convergence towards Global Standards

The last decade has witnessed a sea change in the global economic scenario. The emergence of trans-national corporations in search of money, not only for fuelling growth, but to sustain on going activities has necessitated raising of capital from all parts of the world, cutting across frontiers.

Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-statements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the accounting standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

International analysts and investors would like to compare financial statements based on similar accounting standards, and this has led to the growing support for an internationally accepted set of accounting standards for cross-border filings. The harmonization of financial reporting around the world will help to raise confidence of investors generally in the information they are using to make their decisions and assess their risks.

Also a strong need was felt by legislation to bring about uniformity, rationalization, comparability, transparency and adaptability in financial statements. Having a multiplicity of accounting standards around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system

* Earlier AS 10 was on 'Accounting for Fixed Assets'.

of standards that are being used, then it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers. It creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements.

The convergence of financial reporting and accounting standards is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements. It has the potential to create a new standard of accountability and greater transparency, which are values of great significance to all market participants including regulators. It reduces operational challenges for accounting firms and focuses their value and expertise around an increasingly unified set of standards. It creates an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model. For the companies with joint listings in both domestic and foreign country, the convergence is very much significant.

1.6 International Accounting Standard Board

With a view of achieving these objectives, the London based group namely the International Accounting Standards Committee (IASC), responsible for developing International Accounting Standards, was established in June, 1973. It is presently known as International Accounting Standards Board (IASB), The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India). Primarily, the IASC was established, in the public interest, to formulate and publish, International Accounting Standards to be followed in the presentation of audited financial statements. International Accounting Standards were issued to promote acceptance and observance of International Accounting Standards worldwide. The members of IASC have undertaken a responsibility to support the standards promulgated by IASC and to propagate those standards in their respective countries.

Between 1973 and 2001, the International Accounting Standards Committee (IASC) released International Accounting Standards. Between 1997 and 1999, the IASC restructured their organisation, which resulted in formation of International Accounting Standards Board (IASB). These changes came into effect on 1st April, 2001. Subsequently, IASB issued statements about current and future standards: IASB publishes its Standards in a series of pronouncements called International Financial Reporting Standards (IFRS). However, IASB has not rejected the standards issued by the ISAC. Those pronouncements continue to be designated as "International Accounting Standards" (IAS).

1.7 International Financial Reporting Standards as Global Standards

The term IFRS comprises IFRS issued by IASB; IAS issued by International Accounting Standards Committee (IASC); Interpretations issued by the Standard Interpretations Committee (SIC) and the IFRS Interpretations Committee of the IASB.

International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international standards. This requirement will affect thousands of enterprises, including their subsidiaries, equity investors and joint venture partners. The increased use of IFRS is not limited to public-company listing requirements or statutory reporting. Many lenders and regulatory and government bodies are looking to IFRS to fulfil local financial reporting obligations related to financing or licensing.

1.8 Convergence to IFRS in India

In the scenario of globalisation, India cannot insulate itself from the developments taking place worldwide. In India, so far as the ICAI and the Government authorities such as the National Advisory Committee on Accounting Standards established under the Companies Act, 2013, and various regulators such as Securities and Exchange Board of India and Reserve Bank of India are concerned, the aim is to comply with the IFRS to the extent possible with the objective to formulate sound financial reporting standards for the purpose of preparing globally accepted financial statements. The ICAI, being a member of the International Federation of Accountants (IFAC), considered the IFRS and tried to integrate them, to the extent possible, in the light of the laws, customs, practices and business environment prevailing in India.

Also, the recent stream of overseas acquisitions by Indian companies makes a compelling case for adoption of high quality standards to convince foreign enterprises about the financial standing as also the disclosure and governance standards of Indian acquirers.

In India, the Institute of Chartered Accountants of India (ICAI) has worked towards convergence by considering the application of IFRS in Indian corporate environment of Indian Accounting Standards with Global Standards. Recognising the growing need of full convergence of Indian Accounting Standards with IFRS, ICAI constituted a Task Force to examine various issues involved. Full convergence involves adoption of IFRS in the same form as that issued by the IASB. While formulating the Accounting

Standards, ICAI recognises the legal and other conditions prevailing in India and makes deviations from the corresponding IFRS.

For convergence of Indian Accounting Standards with International Financial Reporting Standards (IFRS), the Accounting Standard Board in consultation with the Ministry of Corporate Affairs (MCA)), has decided that there will be two separate sets of Accounting Standards viz. (i) Indian Accounting Standards converged with the IFRS – standards which are being converged by eliminating the differences of the Indian Accounting Standards vis-à-vis IFRS (known as Ind AS) and (ii) Existing Notified Accounting Standards.

History of IFRS-Converged Indian Accounting Standards (Ind AS)

First Step towards IFRS

The Institute of Chartered Accountants of India (ICAI) being the accounting standards-setting body in India, way back in 2006, initiated the process of moving towards the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) with a view to enhance acceptability and transparency of the financial information communicated by the Indian corporates through their financial statements. This move towards IFRS was subsequently accepted by the Government of India.

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as, various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of profit and loss and other comprehensive income' and 'balance sheet' in place of 'statement of financial position'. Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS.

Government of India - Commitment to IFRS Converged Ind AS

Consistent, comparable and understandable financial reporting is essential to develop a robust economy. With a view to achieve international benchmarks of financial reporting, the Institute of Chartered Accountants of India (ICAI), as a proactive role in accounting, set out to introduce Indian Accounting Standards (Ind AS) converged with the International Financial

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Reporting Standards (IFRS). This endeavour of the ICAI is supported by the Government of India.

Initially Ind AS were expected to be implemented from the year 2011. However, keeping in view the fact that certain issues including tax issues were still to be addressed, the Ministry of Corporate Affairs decided to postpone the date of implementation of Ind AS.

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

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

Unit 2: Overview of Accounting Standards

Learning objectives

After studying this unit you will be able to:

- ◆ Comprehend the status and applicability of accounting standards.
- ◆ Know the scope of various accounting standards.
- ◆ Understand the provisions of the given Accounting Standards.
- ◆ Relate relevant Accounting Standards at various situations and apply them accordingly.
- ◆ Solve the practical problems based on application of Accounting Standards.

2.1 Status of Accounting Standards

It has already been mentioned in unit one of this chapter that the standards are developed by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India and are issued under the authority of its Council. The institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. The accounting standards are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exception as stated below. The implication of mandatory status of an accounting standard depends on whether the statute governing the enterprise concerned requires compliance with the standard.

In assessing whether an accounting standard is applicable, one must find correct answer to the following three questions.

- (a) Does it apply to the enterprise concerned? If yes, the next question is:
- (b) Does it apply to the financial statement concerned? If yes, the next question is:
- (c) Does it apply to the financial item concerned?

The preface to the statements of accounting standards answers the above questions.

Enterprises to which the accounting standards apply

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

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

Implication of mandatory status

Where the statute governing the enterprise does not require compliance with the accounting standards, e.g. a partnership firm, the mandatory status of an accounting standard implies that, in discharging their attest functions, the members of the Institute are required to examine whether the financial statements are prepared in compliance with the applicable accounting standards. (See Scheme of Applicability of Accounting Standards given in para 2.3) In the event of any deviation from the accounting standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

Section 129 (1) of the Companies Act, 2013 requires companies to present their financial statements in accordance with the accounting standards notified under Section 133 of the Companies Act, 2013 (See Note 1). Also, the auditor is required by section 143(3)(e) to report whether, in his opinion, the financial statements of the company audited, comply with the accounting standards referred to in section 133 of the Companies Act, 2013. Where the financial statements of a company do not comply with the accounting standards, the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviations as per Section 129(5) of the Companies Act, 2013. Provided also that the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—

- (a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;
- (b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;
- (c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;
- (d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Note: As per the Companies Act, 2013, the Central Government may prescribe standards of accounting or addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with NACAS. Till date, the Central Government has notified all the existing accounting standards.

Financial items to which the accounting standards apply

The Accounting Standards are intended to apply only to items, which are material. An item is considered material, if its omission or misstatement is likely to affect economic decision of the user. Materiality is not necessarily a function of size; it is the information content i.e. the financial item which is important. A penalty of ₹ 50,000 paid for breach of law by a company can seem to be a relatively small amount for a company incurring crores of rupees in a year, yet is a material item because of the information it conveys. The materiality should therefore be judged on case-to-case basis. If an item is material, it should be shown separately instead of clubbing it with other items. For example it is not appropriate to club the penalties paid with legal charges.

Accounting Standards and Income tax Act, 1961

Accounting standards intend to reduce diversity in application of accounting principles. They improve comparability of financial statements and promote transparency and fairness in their presentation. Deductions and exemptions allowed in computation of taxable income on the other hand, is a matter of fiscal policy of the government.

Thus, an expense required to be charged against revenue by an accounting standard does not imply that the same is always deductible for income tax purposes. For example, depreciation on assets taken on finance lease is charged in the books of lessee as per AS 19 but depreciation for tax purpose is allowed to lessor, being legal owner of the asset, rather than to lessee. Likewise, recognition of revenue in the financial statements cannot be avoided simply because it is exempted under section 10 of the Income Tax Act, 1961.

Income Computation and Disclosure Standards

Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assessee or in respect of any class of income. Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assesseees (other than an individual or a Hindu undivided family who is not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB) following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources", from A.Y. 2017-18. The ten notified ICDSs are:

ICDS I : Accounting Policies

ICDS II : Valuation of Inventories

ICDS III : Construction Contracts

ICDS IV : Revenue Recognition

ICDS V : Tangible Fixed Assets

ICDS VI : The Effects of Changes in Foreign Exchange Rates

ICDS VII : Government Grants

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ICDS VIII : Securities

ICDS IX : Borrowing Costs

ICDS X : Provisions, Contingent Liabilities and Contingent Assets

2.2 Applicability of Accounting Standards

For the purpose of compliance of the accounting Standards, the ICAI had already issued an announcement on 'Criteria for Classification of Entities and Applicability of Accounting Standards' in year 2003. As per the announcement, entities were classified into three levels. Level II entities and Level III entities as per the said Announcement were considered to be Small and Medium Entities (SMEs).

However, when the accounting standards were notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards¹, the Central Government also issued the 'Criteria for Classification of Entities and Applicability of Accounting Standards' for the companies. It is pertinent to note that the accounting standards notified by the government were mandatory for the companies since it was notified under the Act.

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

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

¹ *The Companies Act, 1956 is being replaced by the Companies Act 2013 in a phased manner. Now, as per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA). Section 132 of the Companies Act, 2013 deals with constitution of NFRA. It may be noted that this section is not notified till 30th November, 2016.*

However, the Ministry of Corporate Affairs has, vide clarification dated 13th September, 2013, announced that the existing Accounting Standards notified under the Companies Act, 1956 shall continue to apply till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority.

with the three levels of entities for non-corporate entities vis-à-vis two levels prescribed for corporate entities as per the government notification.

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

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

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

Level I Entities

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

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

Level II Entities (SMEs)

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

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

Level III Entities (SMEs)

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

Additional requirements

- (1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.
- (2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.
- (3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.
- (4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.
- (5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.
- (6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard: Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.
- (7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

2.2.2 Criteria for classification of Companies as per the Companies (Accounting Standards) Rules, 2006

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

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

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

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

Non-SMCs

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

Instructions

A. General Instructions

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

“The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company.”
 - 1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having

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ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

- 1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.
- 1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.
- 1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

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

B. Other Instruction

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

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

2.2.3 Applicability of Accounting Standards to Companies

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

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

AS 10 (Revised)	Property, Plant and Equipment**
AS 11	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13 (Revised)	Accounting for Investments
AS 14 (Revised)	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 22	Accounting for Taxes on Income
AS 24	Discontinuing Operations
AS 26	Intangible Assets

2.2.3.2 Exemptions or Relaxations for SMCs as defined in the Notification

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

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

****Revised AS 10 is on 'Property, Plant and Equipment' which is applicable for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.**

AS 6 has been withdrawn by the MCA on 30.3.2016 for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards. Provisions with respect to Depreciation has been incorporated in revised AS 10.

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- (B) *Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs*:*
- (i) AS 21 (Revised), Consolidated Financial Statements
 - (ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
 - (iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)
- (C) *Accounting Standards** in respect of which relaxations from certain requirements have been given to SMCs:*
- (i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)
 - (ii) AS 19, Leases
 - (iii) AS 20, Earnings Per Share
 - (iv) AS 28, Impairment of Assets
 - (v) AS 29(Revised), Provisions, Contingent Liabilities and Contingent Assets
- (D) *AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.*

2.2.4 Applicability of Accounting Standards to Non-corporate Entities

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

AS 1	Disclosures of Accounting Policies
AS 2 (Revised)	Valuation of Inventories
AS 4 (Revised)	Contingencies and Events Occurring After the Balance Sheet Date

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

** The exemption provisions contained in these standards have not been detailed since these standards do not form part of syllabus of Intermediate (IPC) Paper-1 Accounting.

AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	Construction Contracts
AS 9	Revenue Recognition
AS 10 (Revised)	Property, Plant and Equipment**
AS 11	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13 (Revised)	Accounting for Investments
AS 14 (Revised)	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 22	Accounting for Taxes on Income
AS 26	Intangible Assets

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

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

AS 3	Cash Flow Statements
AS 17	Segment Reporting

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

AS 3	Cash Flow Statements
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****Revised AS 10 is on 'Property, Plant and Equipment' which is applicable for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.**

AS 6 has been withdrawn by the MCA on 30.3.2016 for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.

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AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 24	Discontinuing Operations

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

(i)	AS 21 (Revised), Consolidated Financial Statements
(ii)	AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
(iii)	AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

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

- (i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)
- (ii) AS 19, Leases
- (iii) AS 20, Earnings Per Share
- (iv) AS 28, Impairment of Assets
- (v) AS 29(Revised), Provisions, Contingent Liabilities and Contingent Assets

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

2.3 List of Accounting Standards

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

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

* AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

** The exemption provisions contained in these standards have not been detailed since these standards do not form part of syllabus of Intermediate (IPC) Paper-1 Accounting.

AS No.	AS Title	Date
1	Disclosure of Accounting Policies	01/04/1993
2	Valuation of Inventories (Revised)	01/04/1999
3	Cash Flow Statement	01/04/2001
4	Contingencies and Events Occurring after the Balance Sheet Date (Revised)	01/04/1998
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	01/04/1996
6	Depreciation Accounting	<i>Withdrawn w.e.f 1.4.2016 after issuance of revised AS 10 on PPE</i>
7	Construction Contracts	01/04/2002
8	Research & Development	Now included in AS 26
9	Revenue Recognition	01/04/1993
10	<i>Property, Plant and Equipment (Revised)</i>	01/04/2016
11	The Effects of Changes in Foreign Exchange Rates	01/04/2004
12	Accounting for Government Grants	01/04/1994
13	Accounting for Investments (Revised)	01/04/1995
14	Accounting for Amalgamations (Revised)	01/04/1995
15	Employee Benefits	01/04/2006
16	Borrowing Costs	01/04/2000
17	Segment Reporting	01/04/2001
18	Related Party Disclosures	01/04/2001
19	Leases	01/04/2001
20	Earnings Per Share	01/04/2001
21	Consolidated Financial Statements (Revised)	01/04/2001
22	Accounting for Taxes on Income	01/04/2006
23	Accounting for Investments in Associates in Consolidated Financial Statements	01/04/2002

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24	Discontinuing Operations	01/04/2004
25	Interim Financial Reporting	01/04/2002
26	Intangible Assets	01/04/2003
27	Financial Reporting of Interests in Joint Ventures	01/04/2002
28	Impairment of Assets	01/04/2008
29	Provisions, Contingent Liabilities and Contingent Assets (Revised)	01/04/2004

Note: Accounting Standards 1, 2, 3, 7, 9, 10, 13 and 14 are covered in the Intermediate (IPC) Course (Gr-I) syllabus and have been discussed in detail in the later paras.

2.4 Overview

2.4.1 Disclosure of Accounting Policies (AS 1)

Irrespective of extent of standardization, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard.

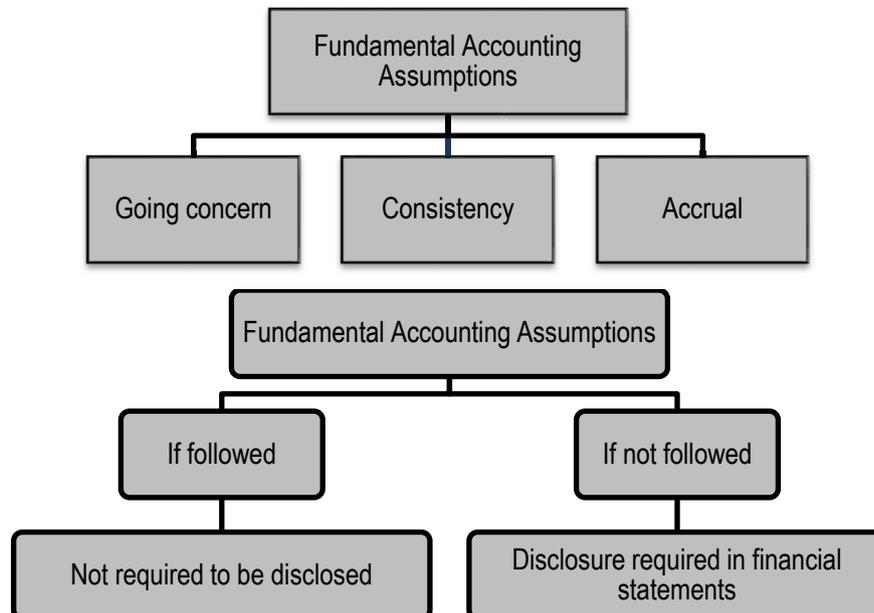
Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time.

The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

The purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial statements of different enterprises for same accounting periods. The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

Accounting Standard 1, Disclosure of Accounting Policies, was first issued November 1979. It came into effect in respect of accounting periods commencing on or after April 1, 1991. The standard applies to all enterprises.

Fundamental Accounting Assumptions (Paragraph 10)



Going Concern: The financial statements are normally prepared on the assumption that an enterprise will continue its operations in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities.

Consistency: The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required (i) by a statute (ii) by an accounting standard (iii) for more appropriate presentation of financial statements.

Accrual basis of accounting: Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it.

While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require

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that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain.

Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting as illustrated below. Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

Accounting Policies

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

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

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

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

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

Selection of Accounting Policy

Financial Statements are prepared to portray a true and fair view of the performance and state of affairs of an enterprise. In selecting a policy, alternative accounting policies should be evaluated in that light. In particular, major considerations that govern selection of a particular policy are:

Prudence: In view of uncertainty associated with future events, profits are not anticipated, but losses are provided for as a matter of conservatism. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. The exercise of prudence in selection of accounting policies ensure that (i) profits are not overstated (ii) losses are not understated (iii) assets are not overstated and (iv) liabilities are not understated.

Example 1

The most common example of exercise of prudence in selection of accounting policy is the policy of valuing inventory at lower of cost and net realisable value.

Suppose a trader has purchased 500 units of certain article @ ₹ 10 per unit. He sold 400 articles @ ₹ 15 per unit. If the net realisable value per unit of the unsold article is ₹ 15, the trader shall value his stock at ₹ 10 per unit and thus ignoring the profit ₹ 500 that he may earn in next accounting period by selling 100 units of unsold articles. If the net realisable value per unit of the unsold article is ₹ 8, the trader shall value his stock at ₹ 8 per unit and thus recognising possible loss ₹ 200 that he may incur in next accounting period by selling 100 units of unsold articles.

Profit of the trader if net realisable value of unsold article is ₹ 15

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times ₹ 15) - (500 \times ₹ 10 - 100 \times ₹ 10) = ₹ 2,000$$

Profit of the trader if net realisable value of unsold article is ₹ 8

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times ₹ 15) - (500 \times ₹ 10 - 100 \times ₹ 8) = ₹ 1,800$$

Example 2

Exercise of prudence does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.

Substance over form: Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

Materiality: Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases quantitative limits of materiality is specified. A few of such cases are given below:

- (a) A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or ₹1,00,000 whichever is higher (Refer general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013).

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- (b) A company shall disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held. (Refer general Instructions for Balance Sheet in Schedule III to the Companies Act, 2013).

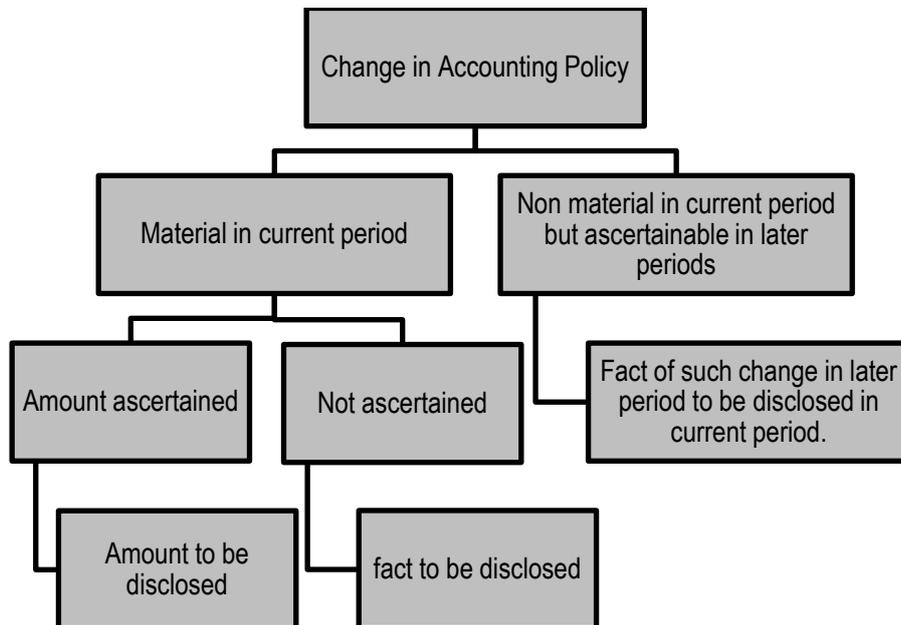
Manner of disclosure: All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed

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

Note: Being a part of the financial statement, the opinion of auditors shall cover the disclosures of accounting policies.

Disclosure of Changes in Accounting Policies

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



Example 3

A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should therefore be disclosed wherever ascertainable. Suppose a company has switched over to weighted average formula for ascertaining cost of inventory, from the earlier practice of using FIFO. If the closing inventory

by FIFO is ₹ 2 lakh and that by weighted average formula is ₹ 1.8 lakh, the change in accounting policy pulls down profit and value of inventory by ₹ 20,000. The company may disclose the change in accounting policy in the following manner:

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

A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period.

The above requirement ensures that all important changes in accounting policies are actually disclosed. Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 2014-15 to include overheads in estimating costs for servicing warranty claims. If value of warranty sales in 2014-15 is not significant, the change in policy will not have any material effect on financial statements of 2014-15. Yet, the company must disclose the change in accounting policy in 2014-15 because the change can affect future accounting periods when value of warranty sales may rise to a significant level. If the disclosure is not made in 2014-15, then no disclosure in future years will be required. This is because an enterprise has to disclose changes in accounting policies in the year of change only.

Disclosure of deviations from fundamental accounting assumptions

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

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy, the disclosure requirements for which are covered by paragraph 26.

2.4.2 Valuation of Inventory (AS 2)

The cost of closing inventory, e.g. cost of closing stock of raw materials, closing work-in-progress and closing finished stock, is a part of costs incurred in the current accounting period that is carried over to next accounting period. Likewise, the cost of opening inventory is a part of costs incurred in the previous accounting period that is brought forward to current accounting period.

Since inventories are assets, and assets are resources expected to cause flow of future economic benefits to the enterprise, the costs to be included in inventory costs, are costs that are expected to generate future economic benefits to the enterprise. Such costs must be costs

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of acquisition and costs that change either (i) the location of the inventory, e.g. freight incurred to carry the materials to factory or (ii) conditions of the inventory, e.g. costs incurred to convert the materials into finished stock.

The costs incurred to maintain the inventory, e.g. storage costs, do not generate any extra economic benefits for the enterprise and therefore should not be included in inventory costs.

The valuation of inventory is crucial because of its direct impact in measuring profit/loss for an accounting period. Higher the value of closing inventory lower is the cost of goods sold and hence larger is the profit. The principle of prudence demands that no profit should be anticipated while all foreseeable losses should be recognised. Thus, if net realisable value of inventory is less than inventory cost, inventory is valued at net realisable value to reduce the reported profit in anticipation of loss. On the other hand, if net realisable value of inventory is more than inventory cost, the anticipated profit is ignored and the inventory is valued at cost. In short, inventory is valued at lower of cost and net realisable value. The standard specifies (i) what the cost of inventory should consist of and (ii) how the net realisable value is determined.

Failure of an item of inventory to recover its costs is unusual. If net realisable value of an item of inventory is less than its cost, the fall in profit in consequence of writing down of inventory to net realisable is an unusual loss and should be shown as a separate line item in the Profit & Loss statement to help the users of financial statements to make a more informed analysis of the enterprise performance.

By their very nature, abnormal gains or losses are not expected to recur regularly. For a meaningful analysis of an enterprise's performance, the users of financial statements need to know the amount of such gains/losses included in current profit/loss. For this reason, instead of taking abnormal gains and losses in inventory costs, these are shown in the Profit and Loss statement in such way that their impact on current profit/loss can be perceived.

Part I of Schedule III to the Companies Act prescribes that valuation mode shall be disclosed for inventory held by companies. AS 2 "Valuation of Inventories" was first issued in June 1981 to supplement the legal requirements. It was revised and made mandatory for all enterprises in respect of accounting periods commencing on or after April 1, 1999.

Paragraph 3 of AS 2 defines inventories as assets held

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

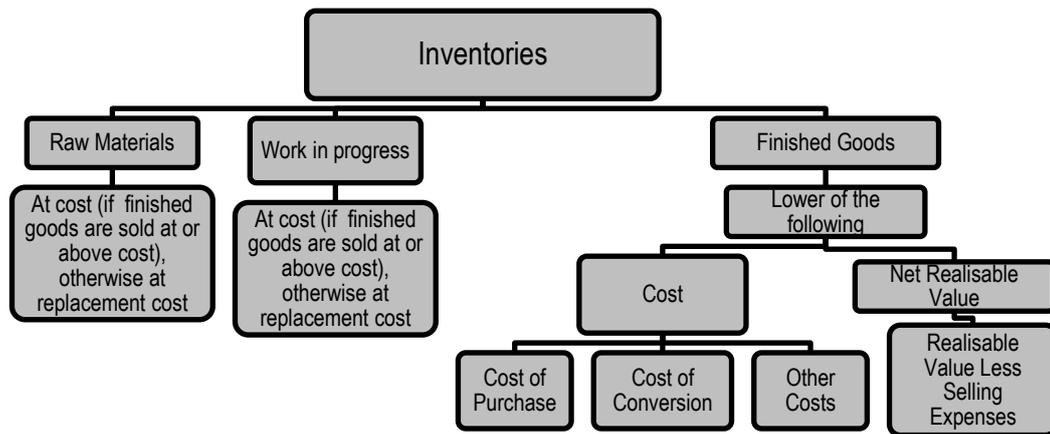
As per paragraph 1 of the Accounting Standards, following are excluded from the scope of AS 2.

- (a) Work in progress arising under construction contracts, i.e. cost of part construction, including directly related service contracts, being covered under AS 7, Accounting for Construction Contracts; Inventory held for use in construction, e.g. cement lying at the site shall however be covered by AS 2.

- (b) Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress. Work-in-progress may arise for different other services e.g. software development, consultancy, medical services, merchant banking and so on.
- (c) Shares, debentures and other financial instruments held as stock-in-trade. It should be noted that these are excluded from the scope of AS 13 as well. The current Indian practice is however to value them at lower of cost and fair value.
- (d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

Measurement of Inventories

Inventories should be valued at lower of cost and net realisable value. As per paragraph 3, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.



Example 1

Cost of a partly finished unit at the end of 2009-10 is ₹ 150. The unit can be finished next year by a further expenditure of ₹ 100. The finished unit can be sold at ₹ 250, subject to payment of 4% brokerage on selling price. The value of inventory is determined below:

	₹
Net selling price	250
Less: Estimated cost of completion	(100)

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	150
Less: Brokerage (4% of 250)	(10)
Net Realisable Value	140
Cost of inventory	150
Value of inventory (Lower of cost and net realisable value)	140

Costs of inventory

Costs of inventories comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of purchase

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Example 2

An enterprise ordered 13,000 Kg. of certain material at ₹ 90 per unit. The purchase price includes GST ₹ 5 per Kg., in respect of which full input tax credit (ITC) credit is admissible. Freight incurred amounted to ₹ 80,600. Normal transit loss is 4%. The enterprise actually received 12,400 Kg and consumed 10,000 Kg.

Cost of inventory and allocation of material cost is shown below:

(Normal cost per Kg.)

	₹
Purchase price (13,000 Kg. x ₹ 90)	11,70,000
Less: Input Tax Credit (13,000 Kg. x ₹ 5)	(65,000)
	11,05,000
Add: Freight	80,600
A. Total material cost	11,85,600
B. Number units normally received = 96% of 13,000 Kg.	Kg. 12,480
C. Normal cost per Kg. (A/B)	95

Allocation of material cost

	Kg.	₹ /Kg.	₹
Materials consumed	10,000	95	9,50,000
Cost of inventory	2,400	95	2,28,000
Abnormal loss	80	95	7,600
Total material cost	12,480	95	11,85,600

Note: Abnormal losses are recognised as separate expense.

Costs of Conversion

The costs of conversion include costs directly related to production, e.g. direct labour. They also include overheads, both fixed and variable. (Paragraph 8)

The fixed production overheads should be absorbed systematically to units of production over normal capacity. Normal capacity is the production the enterprise expects to achieve on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates the normal capacity. The amount of fixed production overheads allocated to each unit of production should not be increased as a consequence of low production or idle plant. Unallocated overheads (i.e. under recovery) are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

Example

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

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

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

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

Joint or By-Products

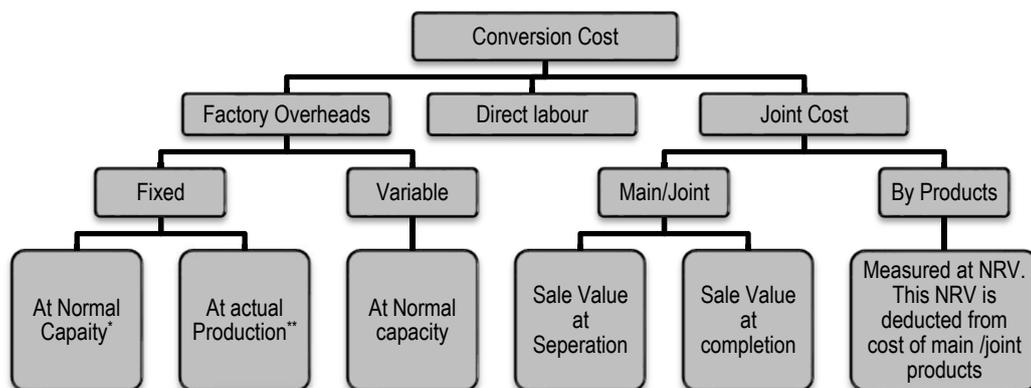
In case of joint or by products, the costs incurred up to the stage of split off should be allocated on a rational and consistent basis. The basis of allocation may be sale value at split

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off point, for example, value of by products, scraps and wastes are usually not material. These are therefore valued at net realisable value. The cost of main product is then valued as joint cost minus net realisable value of by-products, scraps or wastes.

Other Costs

- (a) These may be included in cost of inventory provided they are incurred to bring the inventory to their present location and condition. Cost of design, for example, for a custom made unit may be taken as part of inventory cost. (Paragraph 11)
- (b) Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition. These costs are therefore not usually included in cost of inventory (Paragraph 12). Interests and other borrowing costs however are taken as part of inventory costs, where the inventory necessarily takes substantial period of time for getting ready for intended sale. Example of such inventory is wine.
- (c) The standard is silent on treatment of amortisation of intangibles for ascertaining inventory costs. It nevertheless appears that amortisation of intangibles related to production, e.g. patents right of production or copyright for a publisher should be taken as part of inventory costs.
- (d) Exchange differences are not taken in inventory costs.



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

** When actual production is higher than normal capacity.

Exclusions from the cost of inventories

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- (a) Abnormal amounts of wasted materials, labour, or other production costs;
- (b) Storage costs, unless the production process requires such storage;

- (c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition;
- (d) Selling and distribution costs.

Cost Formula

Mostly inventories are purchased / made in different lots and unit cost of each lot frequently differs. In all such circumstances, determination of closing inventory cost requires identification of units in stock to have come from a particular lot. This specific identification is best wherever possible. In all other cases, the cost of inventory should be determined by the First-In First-Out (FIFO), or Weighted Average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Other techniques of cost measurement

- (a) Instead of actual, the standard costs may be taken as cost of inventory provided standards fairly approximate the actual. Such standards (for finished or partly finished units) should be set in the light of normal levels of material consumption, labour efficiency and capacity utilisation. The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions.
- (b) In retail business, where a large number of rapidly changing items are traded, the actual costs of items may be difficult to determine. The units dealt by a retailer however, are usually sold for similar gross margins and a retail method to determine cost in such retail trades makes use of the fact. By this method, cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin.

Example 4

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

Cost of closing inventory is shown below:

	₹
Sale value of opening stock and purchase ($₹ 85,000 + ₹ 15,000$) $\times 1.25$	1,25,000
Sales	(1,05,000)
Sale value of unsold stock	20,000
Less: Gross Margin ($₹ 20,000 / 1.25$) $\times 0.25$	(4,000)
Cost of inventory	16,000

Estimates of Net Realisable Value

Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events

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occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

Comparison of Cost and Net Realisable Value

The comparison between cost and net realisable value should be made on item-by-item basis. In some cases nevertheless, it may be appropriate to group similar or related items.

Example 5

The cost, net realisable value and inventory value of two items that a company has in its inventory are given below:

	Cost	Net Realisable Value	Inventory Value
	₹	₹	₹
Item 1	50,000	45,000	45,000
Item 2	20,000	24,000	20,000
Total	70,000	69,000	65,000

Estimates of NRV should be based on evidence available at the time of estimation.

As per paragraph 3 of the standard, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Paragraph 22 also provides that estimates of net realisable value are to be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

NRV of materials held for use or disposal

Materials and other supplies held for use in the production of inventories are not written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product. The reason is, as long as these conditions hold the material realises more than its cost as shown below.

Review of net realisable value at each balance sheet date

If an item of inventory remains at more than one balance sheet dates, paragraph 25 of AS 2 requires reassessment of net realisable value of the item at each balance sheet date. The standard is silent whether an item of inventory carried at net realisable value, can be written up on subsequent increase of net realisable value.

Disclosures

Paragraph 26 of AS 2 requires financial statements to disclose:

- accounting policies adopted in measuring inventories, including the cost formula used
- total carrying amount of inventories and its classification appropriate to the enterprise.

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

- (1) raw materials and components,
- (2) work in progress,
- (3) finished goods,
- (4) Stock-in-trade (in respect of goods acquired for trading),
- (5) stores and spares,
- (6) loose tools, and
- (7) Others (specify nature).

2.4.3 Cash Flow Statement (AS 3)

Traditional financial statements comprised of a balance sheet portraying at the end of accounting period, resources controlled by the reporting enterprise together with sources of funds used for their acquisition and a statement of income, showing income, expenses and profit earned or loss incurred by the reporting enterprise during the accounting period. It was however noticed that due to use of accrual basis of accounting, recognition of financial elements, e.g. assets, liabilities, income, expenses and equity, coincide with the events to which they relate rather than with cash receipts or payments. For this reason, traditional financial statements fail to inform the users the way the reporting enterprise has generated cash and the way these were utilised during the accounting period. To a person, less accustomed with accounting practices, it may sometimes appear perplexing to observe that despite earning large profit, an enterprise is left with very little cash to pay dividends. The need for inclusion of a summary of cash receipts and payments in the financial statements of the reporting enterprise was therefore recognised. The summary of cash receipts and payments during an accounting period is called the Cash Flow Statement.

A simple example is given below to illustrate the relation of cash flow with profitability of an enterprise.

Status of AS 3

The standard is mandatory for Level 1 enterprises in respect of accounting periods commencing on or after April 1, 2001. The Level II and Level III non-corporate entities and Level II corporate entities are encouraged but not required to apply the standard.

Meaning of the term cash for cash flow statements

Cash for the purpose of cash flow statement consists of the following:

- (a) Cash in hand and deposits repayable on demand with any bank or other financial institutions and

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- (b) Cash equivalents, which are short term, highly liquid investments that are readily convertible into known amounts of cash and are subject to insignificant risk or change in value. A short-term investment is one, which is due for maturity within three months from the date of acquisition. Investments in shares are not normally taken as cash equivalent, because of uncertainties associated with them as to realisable value.

Note : For the purpose of cash flow statement, 'cash' consists of at least three balance sheet items, viz. cash in hand; demand deposits with banks etc. and investments regarded as cash equivalents. For this reason, the paragraph 42 of the standard requires enterprises to give a break-up of opening and closing cash shown in their cash flow statements. This is presented as a note to cash flow statement.

Meaning of the term cash flow

Cash flows are inflows (i.e. receipts) and outflows (i.e. payments) of cash and cash equivalents. Any transaction, which does not result in cash flow, should not be reported in the cash flow statement. Movements within cash or cash equivalents are not cash flows because they do not change cash as defined by AS 3, which is sum of cash, bank and cash equivalents. For example, acquisitions of cash equivalent investments or cash deposited into bank are not cash flows.

It is important to note that a change in cash does not necessarily imply cash flow. *For example suppose an enterprise has a bank balance of USD 10,000, stated in books at ₹ 4,90,000 using the rate of exchange ₹ 49/USD prevailing on date of receipt of dollars. If the closing rate of exchange is ₹ 50/USD, the bank balance will be restated at ₹ 5,00,000 on the balance sheet date. The increase is however not a cash flow because neither there is any cash inflow nor there is any cash outflow.*

Types of cash flow

Cash flows for an enterprise occur in various ways, e.g. through operating income or expenses, by borrowing or repayment of borrowing or by acquisition or disposal of fixed assets. The implication of each type of cash flow is clearly different. Cash received on disposal of a useful fixed asset is likely to have adverse effect on future performance of the enterprise and it is completely different from cash received through operating income or cash received through borrowing. It may also be noted that implications cash flow types are interrelated. For example, borrowed cash used for meeting operating expenses is not same as borrowed cash used for acquisition of useful fixed assets.

For the aforesaid reasons, the standard identifies three types of cash flows, i.e. investing cash flows, financing cash flows and operating cash flows. Separate presentation of each type of cash flow in the cash flow statement improves usefulness of cash flow information.

The investing cash flows are cash flows generated by investing activities. The investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The examples of investing cash flows include cash flow arising from investing activities include: (a) receipts from disposals of fixed assets; (b) loan given to /

recovered from other entities (other than loans by financial enterprises) (c) payments to acquire fixed assets (d) Interests and dividends earned (other than interests and dividends earned by financial institutions).

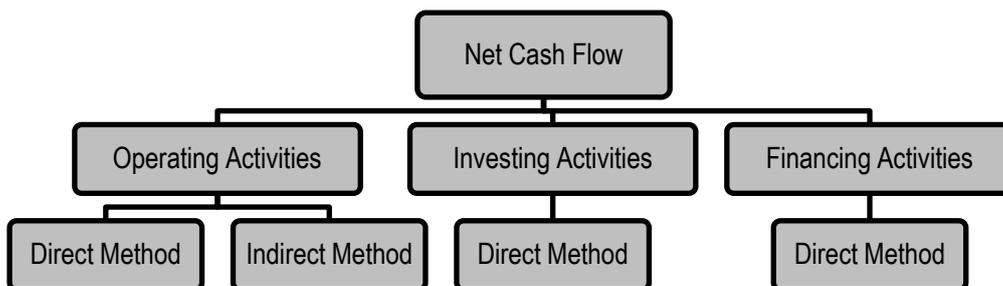
The financing cash flows are cash flows generated by financing activities. Financing activities are activities that result in changes in the size and composition of the owners' capital (including preferences share capital in the case of company) and borrowings of the enterprise. Examples include issue of shares / debentures, redemption of debentures / preference shares, payment of dividends and payment of interests (other than interests paid by financial institutions).

The operating cash flows are cash flows generated by operating activities or by other activities that are not investing or financing activities. Operating activities are the principal revenue-producing activities of the enterprise. Examples include, cash purchase and sale of goods, collections from customers for goods, payment to suppliers of goods, payment of salaries, wages etc.

Identifying type of cash flows

Cash flow type depends on the business of the enterprise and other factors. For example, since principal business of financial enterprises consists of borrowing, lending and investing, loans given and interests earned are operating cash flows for financial enterprises and investing cash flows for other enterprises. A few typical cases are discussed below.

Classification Cash Flows



Loans/Advances given and Interests earned

- (a) Loans and advances given and interests earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances given and interests earned on them are investing cash flows for non-financial enterprises.
- (c) Loans and advances given to subsidiaries and interests earned on them are investing cash flows for all enterprises.

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- (d) Loans and advances given to employees and interests earned on them are operating cash flows for all enterprises.
- (e) Advance payments to suppliers and interests earned on them are operating cash flows for all enterprises.
- (f) Interests earned from customers for late payments are operating cash flows for non-financial enterprises.

Loans/Advances taken and interests paid

- (a) Loans and advances taken and interests paid on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances taken and interests paid on them are financing cash flows for non-financial enterprises.
- (c) Loans and advances taken from subsidiaries and interests paid on them are investing cash flows for all enterprises.
- (d) Advance taken from customers and interests paid on them are operating cash flows for non-financial enterprises.
- (e) Interests paid to suppliers for late payments are operating cash flows for all enterprises.
- (f) Interests taken as part of inventory costs in accordance with AS 16 are operating cash flows.

Investments made and dividends earned

- (a) Investments made and dividends earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Investments made and dividends earned on them are investing cash flows for non-financial enterprises.
- (c) Investments in subsidiaries and dividends earned on them are investing cash flows for all enterprises.

Dividends Paid

Dividends paid are financing cash outflows for all enterprises.

Income Tax

- (a) Tax paid on operating income is operating cash outflows for all enterprises
- (b) Tax deducted at source against income are operating cash outflows if concerned incomes are operating incomes and investing cash outflows if the concerned incomes are investment incomes, e.g. interest earned.

- (c) Tax deducted at source against expenses are operating cash inflows if concerned expenses are operating expenses and financing cash inflows if the concerned expenses are financing expenses, e.g. interests paid.

Insurance claims received

- (a) Insurance claims received against loss of stock or loss of profits are extraordinary operating cash inflows for all enterprises.
- (b) Insurance claims received against loss of fixed assets are extraordinary investing cash inflows for all enterprises.

Paragraph 28 of the standard requires separate disclosure of extraordinary cash flows, classifying them as cash flows from operating, investing or financing activities, as may be appropriate.

Profit or loss on disposal of fixed assets

Profit or loss on sale of fixed asset is not operating cash flow. The entire proceeds of such transactions should be taken as cash inflow from investing activity.

Fundamental techniques of cash flow preparation

A cash flow statement is a summary of cash receipts and payments of an enterprise during an accounting period. Any attempt to compile such a summary from cashbooks is impractical due to the large volume of transactions. Fortunately, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

There are two methods, by which operating cash flows can be presented. By direct approach, the operating cash flows are presented under broad headings, e.g. cash received from customers and cash paid to suppliers and employees. By the indirect approach, operating cash flows are obtained by adjusting profits for changes in working capital and for non-cash charges, e.g. depreciation.

Reporting Cash Flows on Net Basis

Paragraph 21 of the standard forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets. *For example, if an enterprise pays ₹ 50,000 in acquisition of machinery and realises ₹ 10,000 on disposal of furniture, it is not right to show net cash outflow of ₹ 40,000. The exceptions to this rule are stated in paragraphs 22 and 24.*

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

- (a) Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.
- (b) Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

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

- (a) Cash flows on acceptance and repayment of fixed deposits
- (b) Cash flows on placement and withdrawal deposits from other financial enterprises
- (c) Cash flows on advances/loans given to customers and repayments received therefrom.

Non-Cash transactions

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

Business Purchase

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

- (a) The cash flows from disposal and acquisition should not be netted off. (Paragraph 39)
- (b) As per paragraph 38, an enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:
 - (i) The total purchase or disposal consideration; and
 - (ii) The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

Treatment of current assets and liabilities taken over on business purchase

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

Exchange gains and losses

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

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance

sheet date. The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated exclusive of exchange gains and losses. The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement.

Disclosures

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

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

- (a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- (b) The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

Example 1

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

- a. **Purchase of Machinery.**
- b. **Proceeds from issuance of equity share capital**
- c. **Cash Sales.**
- d. **Proceeds from long-term borrowings.**
- e. **Proceeds from Trade receivables.**
- f. **Cash receipts from Trade receivables.**
- g. **Trading Commission received.**
- h. **Purchase of investment.**
- i. **Redemption of Preference Shares.**
- j. **Cash Purchases.**
- k. **Proceeds from sale of investment**
- l. **Purchase of goodwill.**
- m. **Cash paid to suppliers.**

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- n. Interim Dividend paid on equity shares.*
- o. Wages and salaries paid.*
- p. Proceed from sale of patents.*
- q. Interest received on debentures held as investment.*
- r. Interest paid on Long-term borrowings.*
- s. Office and Administration Expenses paid*
- t. Manufacturing Overheads paid.*
- u. Dividend received on shares held as investments.*
- v. Rent Received on property held as investment.*
- w. Selling and distribution expense paid.*
- x. Income tax paid*
- y. Dividend paid on Preference shares.*
- z. Underwritings Commission paid.*
- aa. Rent paid.*
- bb. Brokerage paid on purchase of investments.*
- cc. Bank Overdraft*
- dd. Cash Credit*
- ee. Short-term Deposits*
- ff. Marketable Securities*
- gg. Refund of Income Tax received.*

Solution

- (a) Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.*
- (b) Investing Activities: a, h, k, l, p, q, u, v, bb & ee.*
- (c) Financing Activities: b, d, i, n, r, y, z, cc & dd.*
- (d) Cash Equivalent: ff.*

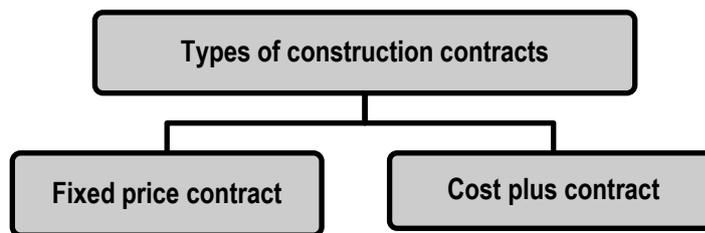
Note : For details regarding preparation of Cash Flow Statement and Problems based on practical application of AS 3, students are advised to refer unit 2 of Chapter 2.

2.4.4 Construction Contracts (AS 7)

Accounting Standard 7 prescribes the principles of accounting for construction contracts in the financial statements of contractors. The focus of the standard is on principles of revenue recognition by the contractors. The standard was initially issued in December 1983 and had the

title "Accounting for Construction Contracts". The standard was revised later and the revised standard applies to all enterprises in respect of construction contracts entered into during accounting periods commencing on or after April 1, 2003.

A construction contract is one, by which a contractor agrees to build some asset for his customer. The contractor's profit is the excess of contract price over construction costs. The contract price may or may not be fixed.



In a **fixed price contract**, the price is agreed as fixed sum. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations.

In a **cost plus contract**, the customer undertakes to reimburse specified costs together with a fee calculated as percentage on reimbursable costs. The fee is the contractor's margin of profit.

Percentage completion method

Construction contracts are mostly long term, i.e. they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with corresponding construction costs incurred in that year. This method of accounting, called the percentage completion method, provides useful information on the extent of contract activity and performance during an accounting period.

The percentage completion method suffers from a serious drawback viz. anticipation of profit. Since the method recognises revenue pending final outcome of a contract is known, it is possible that an enterprise may distribute dividend based on reported profit of a year, while final result is loss. To avoid such possibilities, percentage completion method should be used with caution. The AS 7 prescribes that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract. Also, paragraph 35 of the standard provides that whenever total contract cost is expected to exceed the total contract revenue, the loss should be recognised as an expense immediately.

As per paragraph 22, the outcome of fixed price contracts can be estimated reliably **when all the following conditions are satisfied:**

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- (i) total contract revenue can be measured reliably;
- (ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;
- (iii) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
- (iv) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

As per paragraph 23, the outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:

- (i) it is probable that the economic benefits associated with the contract will flow to the enterprise; and
- (ii) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/13. The fixed contract price agreed was ₹ 2,00,000. The company incurred ₹ 81,000 in 2013-14 for 45% work and received ₹ 79,000 as progress payment from the customer. The cost incurred in 2014-15 was ₹ 89,000 to complete the rest of work.

Solution:

Profit & Loss Account

Year		₹ 000	Year		₹ 000
2013-14	To Construction Costs (for 45% work)	81	2013-14	By Contract Price (45% of Contract Price)	90
	To Net profit (for 45% work)	9			
		90			90
2014-15	To Construction costs (for 55% work)	89	2014-15	By Contract Price (55% of Contract Price)	110
	To Net Profit (for 55% work)	21			
		110			110

Customer Account

Year		₹ 000	Year		₹ 000
2013-14	To Contract Price	90	2013-14	By Bank	79
				By Balance c/d	11
		90			90

2014-15	To Balance b/d	11	2014-15		
	To Contract Price	110		By Bank	121
		121			121

The amount of contract revenue recognised in the statement of profit and loss as per the requirements of AS 7 should be considered as turnover. This means, the revenue recognised by percentage completion method should not be described as work-in progress. It may also be noted that as per the scheme for applicability of accounting standards, enterprises having turnover exceeding ₹ 50 crores treated as level I enterprises. The proportionate revenue recognised in the statement of profit and loss by a contractor, should be taken in computation of turnover for the purpose of the scheme. This is important because level I enterprises are required to comply with all applicable accounting standards in entirety.

The paragraph 31 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

- revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
- contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should however be recognised as an expense immediately.

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method. (Para 34)

Example 2

X Ltd. commenced a construction contract on 01/04/13. The contract price agreed was reimbursable cost plus 20%. The company incurred ₹ 1,00,000 in 2013-14, of which ₹ 90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at ₹ 5,000. The other costs to complete the contract could not be estimated reliably.

The Profit & Loss A/c extract of X Ltd. for 2013-14 is shown below:

Profit & Loss Account

	₹ 000		₹ 000
To Construction Costs	100	By Contract Price	90
To Provision for loss	5	By Net loss	15
	105		105

Treatment of costs relating to future activity (Para 26)

Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract

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costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

Uncollectable Contract Revenue (Para 27)

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

Stage of Completion (Para 29)

The stage of completion of a contract may be determined in a variety of ways. Depending on the nature of the contract, the methods may include:

- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
- (b) surveys of work performed; or
- (c) completion of a physical proportion of the contract work.

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

Example 3

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

	₹ 000
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

Solution

	₹ 000
A. Cost incurred to date	390
B. Estimate of cost to completion	<u>260</u>
C. Estimated total cost	<u>650</u>
D. Degree of completion (A/C)	60%
E. Revenue Recognized (60% of 600)	360
Total foreseeable loss (650 – 600)	50
Less: Loss for current year (E – A)	<u>(30)</u>
Expected loss to be recognised immediately	<u>20</u>

Profit & Loss A/c

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

Combining and Segmenting Construction Contracts

A contractor may undertake a number of contracts. The percentage completion method may not however be appropriate in all cases. Each of the contracts should be tested on the basis of respective facts for electing the appropriate method of revenue recognition. The standard identifies certain cases where for the purposes of accounting, (i) More than one contract can be taken as one and (ii) a single contract can be taken as to comprise of more than one contract.

- (a) When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:
- (i) separate proposals have been submitted for each asset;
 - (ii) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
 - (iii) the costs and revenues of each asset can be identified.
- (b) A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:
- (i) the group of contracts is negotiated as a single package;
 - (ii) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - (iii) the contracts are performed concurrently or in a continuous sequence.
- (c) 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. As per paragraph 9, the construction of the additional asset should be treated as a separate construction contract when:
- (i) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
 - (ii) the price of the asset is negotiated without regard to the original contract price.

Example 4

Mr. Shyam, a construction contractor undertakes the construction of an industrial complex. He has separate proposals raised for each unit to be constructed in the

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industrial complex. Since each unit is subject to separate negotiation, he is able to identify the costs and revenues attributable to each unit. Should Mr. Shyam treat construction of each unit as a separate construction contract according to AS 7?

Solution

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

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

Therefore, Mr. Shyam is required to treat construction of each unit as a separate construction contract.

Contract Revenue and costs

- (a) As per paragraph 10, contract revenue should comprise:
 - (i) the initial amount of revenue agreed in the contract; and
 - (ii) variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.
- (b) As per paragraph 15, contract costs should comprise:
 - (i) costs that relate directly to the specific contract;
 - (ii) costs that are attributable to contract activity in general and can be allocated to the contract; and
 - (iii) such other costs as are specifically chargeable to the customer under the terms of the contract.

Note:

1. Direct costs can be reduced by incidental income, e.g. sale of surplus material, not included in contract revenue. (Paragraph 16)
2. The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16. (Paragraph 17)

Changes in Estimates (Para 37)

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

accordance with AS 5. 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.

Disclosure

- (a) The paragraph 38 requires an enterprise to disclose:
 - (i) the amount of contract revenue recognised as revenue in the period;
 - (ii) the methods used to determine the contract revenue recognised in the period; and
 - (iii) the methods used to determine the stage of completion of contracts in progress.
- (b) The paragraph 39 requires the following disclosures in respect of contracts in progress at the reporting date:
- (c) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
 - (i) the amount of advances received; and
 - (ii) the amount of retentions.
- (d) The Paragraph 41 requires an enterprise to present:
 - (i) the gross amount due from customers for contract work as an asset; and
 - (ii) the gross amount due to customers for contract work as a liability.

2.4.5 Revenue Recognition (AS 9)

This Standard is mandatory for all enterprises.

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

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

- i. Revenue arising from construction contracts;
- ii. Revenue arising from hire-purchase, lease agreements;
- iii. Revenue arising from government grants and other similar subsidies;
- iv. Revenue of insurance companies arising from insurance contracts.

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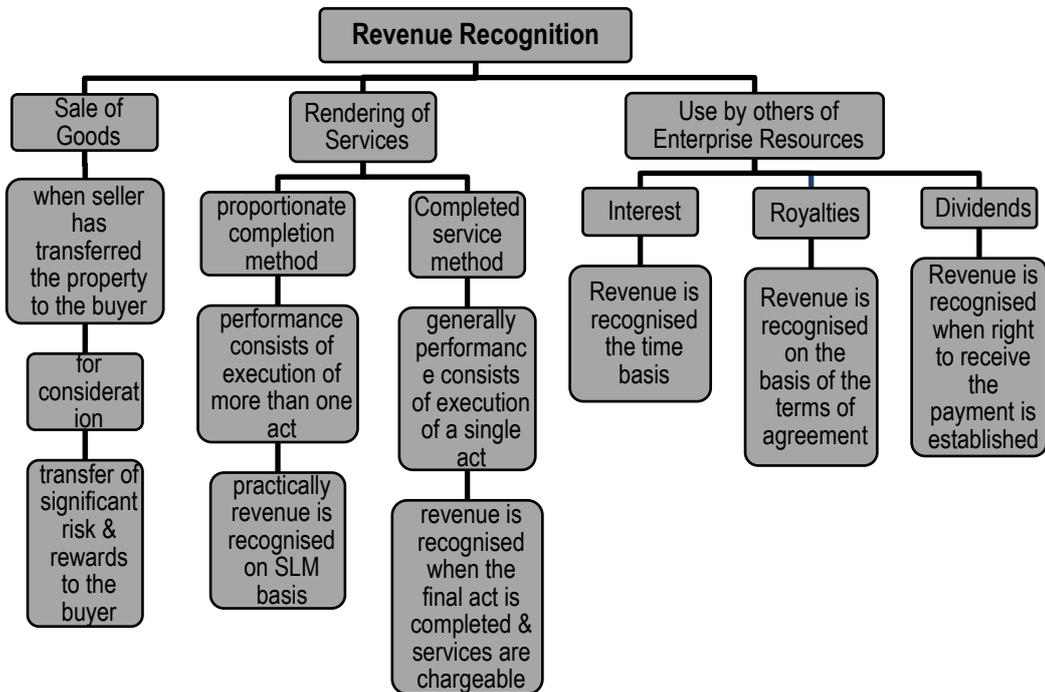
Examples of items not included within the definition of “revenue” for the purpose of this Statement are:

- i. Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
- ii. Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
- iii. Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
- iv. Realised gains resulting from the discharge of an obligation at less than its carrying amount;
- v. Unrealised gains resulting from the restatement of the carrying amount of an obligation.

Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

**Example 1**

The stages of production and sale of a producer are as follow:

Date	Activity	Costs to date ₹	Net Realisable Value ₹
20.1.12	Raw Materials	10,000	8,000
25.1.12	WIP 1	12,000	13,000
27.1.12	WIP 2	15,000	19,000
25.2.12	Finished Product	17,000	30,000
12.3.12	Ready for Sale	17,000	30,000
27.3.12	Sale Agreed and invoice raised	19,000	30,000
02.4.12	Delivered and paid for	19,000	30,000

Explain the stage on which you think revenue will be recognized and state how much would be net profit on a unit of this product according to AS 9?

Solution

According to AS 9, sales will be recognized only when following two conditions are satisfied:

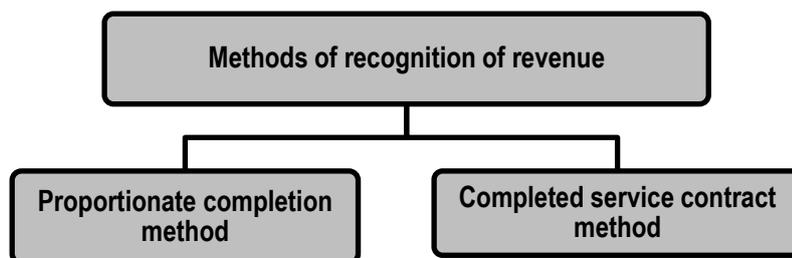
- (i) The sale value is fixed and determinable.
- (ii) Property of the goods is transferred to the customer.

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Both these conditions are satisfied only on 27.3.2012 when sales are agreed upon at a price and goods are allocated for delivery purpose. The amount of net profit ₹ 11,000 (30,000 – 19,000) would be recognized in the books for the year ending 31st March, 2012.

Rendering of Services

Revenue from service transactions is usually recognised as the service is performed. There are two methods of recognition of revenue from service transaction, viz,



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

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

Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

Use by others of such enterprise resources gives rise to:

- i. Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable.
- ii. Royalties: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement.
- iii. Dividends: rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established.

Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

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

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

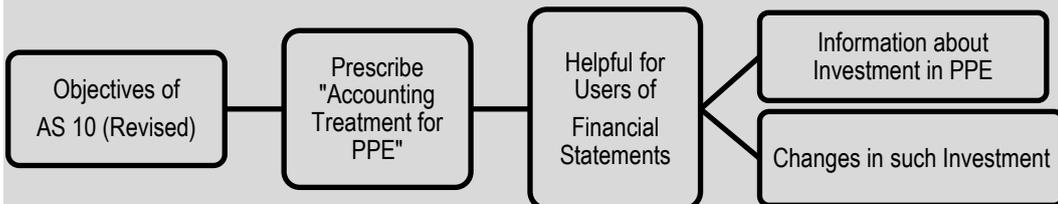
Disclosure

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

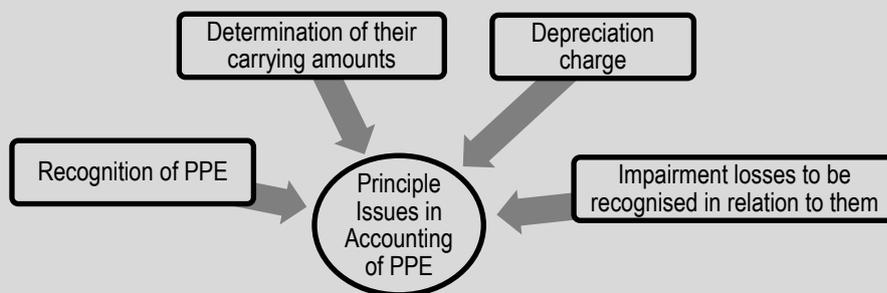
2.4.6 Property, Plant and Equipment (AS 10)

INTRODUCTION

The objective of this Standard is to prescribe accounting treatment for Property, Plant and Equipment (PPE).



The principal issues in Accounting for PPE are:



SCOPE OF THE STANDARD

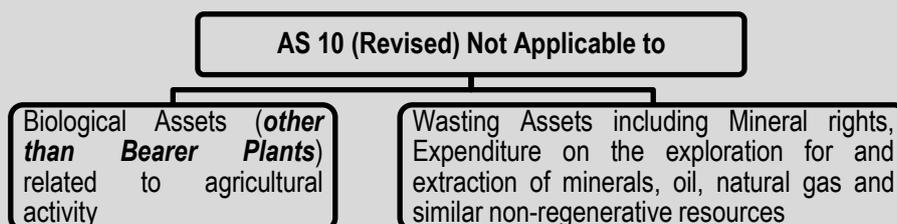
As a general principle, AS 10 (Revised) should be applied in accounting for PPE.

Exception:

When another Accounting Standard requires or permits a different accounting treatment.

Example: AS 19² on Leases, requires an enterprise to evaluate its recognition of an item of leased PPE on the basis of the transfer of risks and rewards. However, it may be noted that in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

This Standard does not apply to:



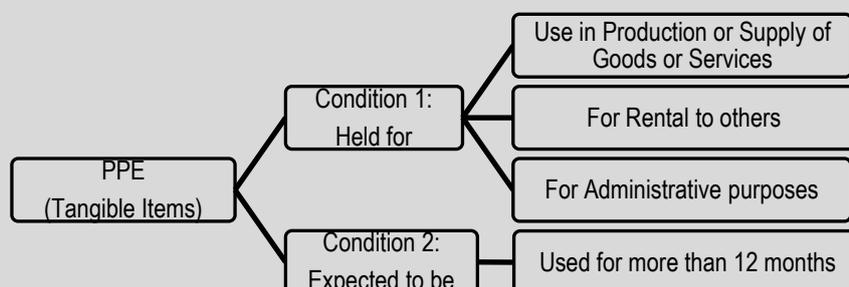
Note: AS 10 (Revised) applies to Bearer Plants but it does not apply to the produce on Bearer Plants.

Clarifications:

- AS 10 (Revised) applies to PPE used to develop or maintain the assets described above.
- Investment property (defined in AS 13 (Revised)), should be accounted for only in accordance with the Cost model prescribed in this standard.

DEFINITION OF PROPERTY, PLANT AND EQUIPMENT(PPE)

There are 2 conditions to be satisfied for a TANGIBLE item to be called PPE. PPE are tangible items that:



² The students may note that AS 19 on Leases is not covered in syllabus of Intermediate Paper 1: Accounting syllabus.

Note: Intangible items are covered under AS 26.

“Administrative purposes”: The term ‘Administrative purposes’ has been used in wider sense to include all business purposes. Thus, PPE would include assets used for:

- Selling and distribution
- Finance and accounting
- Personnel and other functions of an Enterprise.

Items of PPE may also be acquired for safety or environmental reasons.

The acquisition of such PPE, although not directly increasing the future economic benefits of any particular existing item of PPE, may be necessary for an enterprise to obtain the future economic benefits from its other assets.

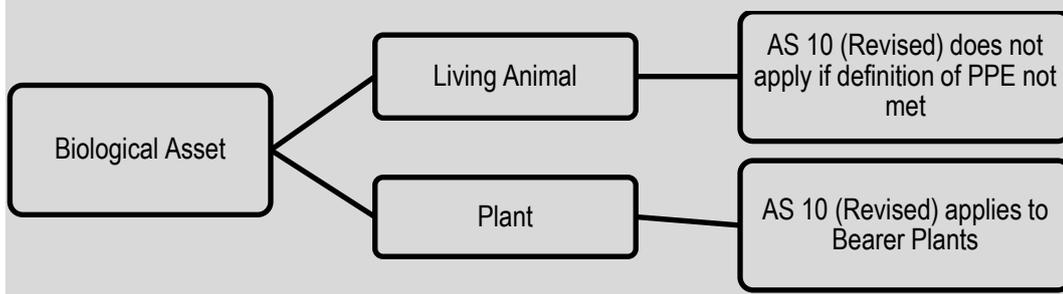
Such items of PPE qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

Example: A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals.

The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28 (Impairment of Assets)³.

OTHER DEFINITIONS

1. **Biological Asset:** An Accounting Standard on “Agriculture” is under formulation, which will, inter alia, cover accounting for livestock. Till the time, the Accounting Standard on “Agriculture” is issued, accounting for livestock meeting the definition of PPE, will be covered as per AS 10 (Revised).



³ The students may note that AS 28 on Impairment of Assets is not covered in syllabus of Intermediate Paper 1: Accounting syllabus.

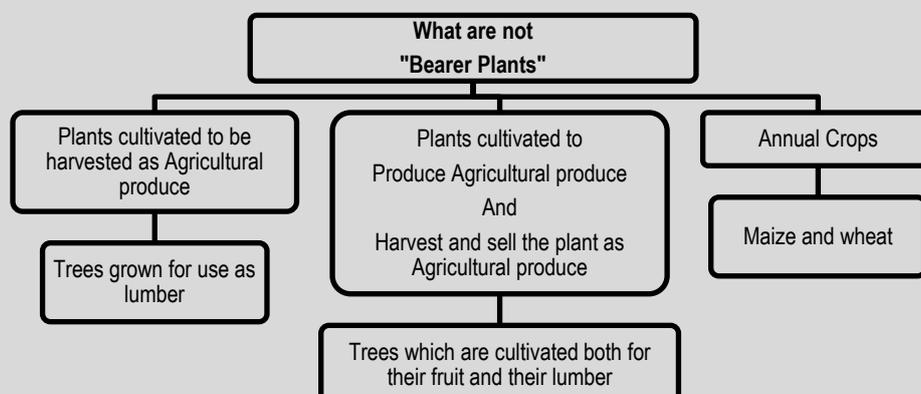
2. **Bearer Plant:** Is a plant that (satisfies all 3 conditions):

	Is used in the production or supply	• Of Agricultural produce
	Is expected to bear produce	• For more than a period of 12 months
	Has a remote likelihood of being sold as Agricultural produce	• Except for incidental scrap sales

Note: When bearer plants are no longer used to bear produce they might be cut down and sold as scrap. For example - use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a Bearer Plant.

The following are not Bearer Plants:

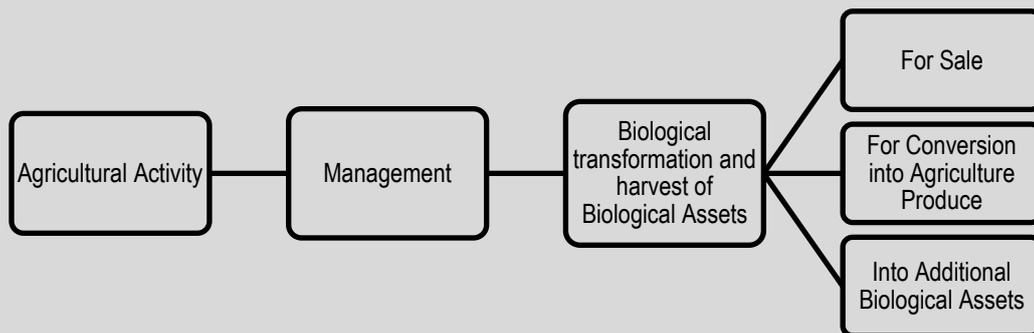
- (a) Plants cultivated to be *harvested as* Agricultural produce
Example: Trees grown for use as lumber
- (b) Plants cultivated *to produce* Agricultural produce when there is more than a remote likelihood that the entity will *also harvest and sell* the plant as agricultural produce, other than as incidental scrap sales
Example: Trees which are cultivated both for their fruit and their lumber
- (c) Annual crops
Example: **Maize and wheat**



Agricultural Produce is the harvested product of Biological Assets of the enterprise.

3. **Agricultural Activity:** Is the management by an Enterprise of:

- Biological transformation; and
- Harvest of Biological Assets
- For sale, Or
- For conversion into Agricultural Produce, Or
- Into additional Biological Assets



RECOGNITION CRITERIA FOR PPE

The cost of an item of PPE should be recognised as an asset if, and only if:

- (a) It is probable that future economic benefits associated with the item will flow to the enterprise, and
- (b) The cost of the item can be measured reliably.

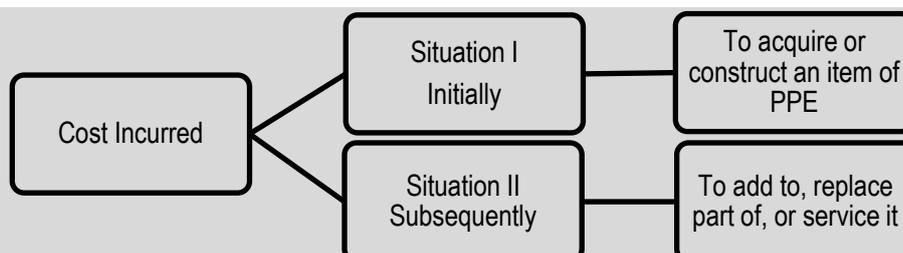
Notes:

1. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies and to apply the criteria to the aggregate value.
2. An enterprise may decide to expense an item which could otherwise have been included as PPE, because the amount of the expenditure is not material.

When do we apply the above criteria for Recognition?

An enterprise evaluates under this recognition principle all its costs on PPE at the time they are incurred.

These costs include costs incurred:



TREATMENT OF SPARE PARTS, STAND BY EQUIPMENT AND SERVICING EQUIPMENT

Case I If they meet the definition of PPE as per AS 10 (Revised):

- **Recognised as PPE as per AS 10 (Revised)**

Case II If they do not meet the definition of PPE as per AS 10 (Revised):

- **Such items are classified as Inventory as per AS 2 (Revised)**

Illustration 1 (Capitalising the cost of “Remodelling” a Supermarket)

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

Solution

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

TREATMENT OF SUBSEQUENT COSTS

Cost of day-to-day servicing

Meaning:

Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of such expenditures is often described as for the ‘Repairs and Maintenance’ of the item of PPE.

Accounting Treatment:

An enterprise does not recognise in the carrying amount of an item of PPE the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the Statement of Profit and Loss as incurred.

Replacement of Parts of PPE

Parts of some items of PPE may require replacement at regular intervals.

Examples:

1. A furnace may require relining after a specified number of hours of use.
2. Aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.
3. Major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system.
4. Replacing the interior walls of a building, or to make a non-recurring replacement.

Accounting Treatment:

An enterprise recognises in the carrying amount of an item of PPE the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met.

Note: The carrying amount of those parts that are replaced is derecognised in accordance with the de-recognition provisions of this Standard.

9.7.3 Regular Major Inspections - Accounting Treatment

When each major inspection is performed, its cost is recognised in the carrying amount of the item of PPE as a replacement, if the recognition criteria are satisfied.

Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

Illustration 2

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

Solution

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

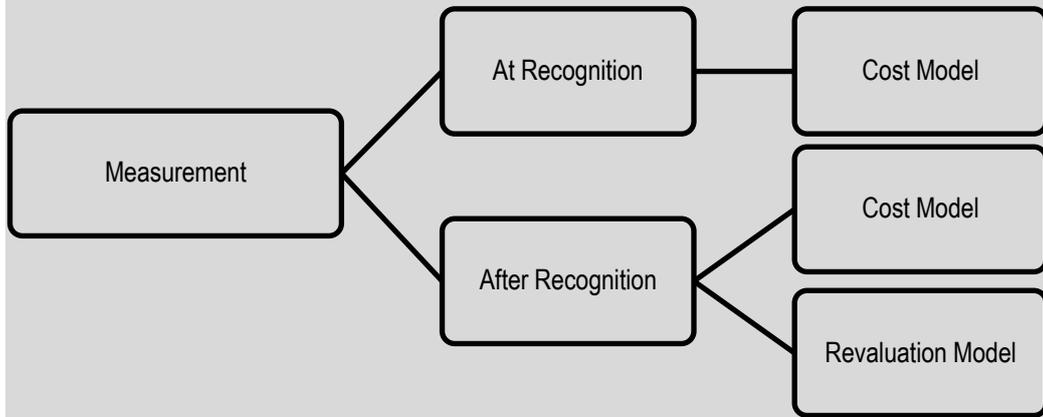
Illustration 3

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

Solution

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

MEASUREMENT OF PPE

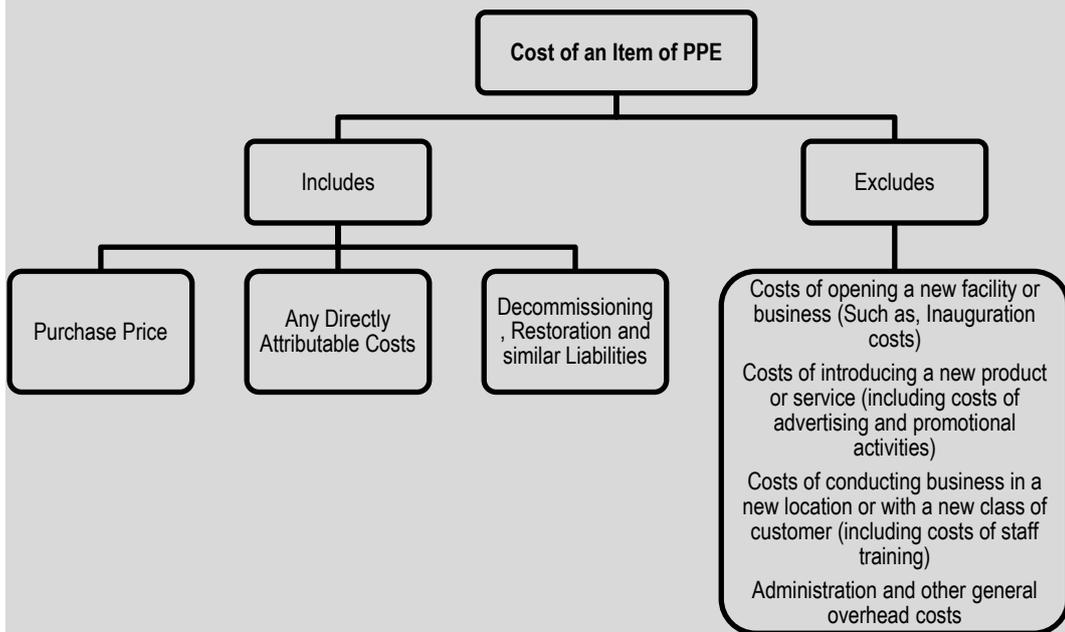


Measurement at Recognition

An item of PPE that qualifies for recognition as an asset should be measured at its cost.

What are the elements of Cost?

Cost of an item of PPE comprises:



Let us understand the above in detail.

A. Purchase Price:

- It includes import duties and non –refundable purchase taxes.
- It requires deduction of Trade discounts and rebates

B. Directly Attributable Costs:

Any costs directly attributable to bringing the asset to the 'location and condition' necessary for it to be capable of operating in the manner intended by management

Recognition of costs in the carrying amount of an item of PPE ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management.

The following costs are not included in the carrying amount of an item of PPE:

1. Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.
2. Initial operating losses, such as those incurred while demand for the output of an item builds up. And
3. Costs of relocating or reorganising part or all of the operations of an enterprise.

Examples of directly attributable costs are:

1. Costs of employee benefits (as defined in AS 15) arising directly from the construction or acquisition of the item of PPE
2. Costs of site preparation
3. Initial delivery and handling costs
4. Installation and assembly costs
5. Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)
6. Professional fees

Examples of costs that are not costs of an item of property, plant and equipment are:

- (a) costs of opening a new facility or business, such as, inauguration costs
- (b) costs of introducing a new product or service (including costs of advertising and promotional activities)
- (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training)
- (d) administration and other general overhead costs

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Note: Some operations occur in connection with the construction or development of an item of PPE, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities.

Example: Income may be earned through using a building site as a car park until construction starts because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in the Statement of Profit and Loss and included in their respective classifications of income and expense.

Illustration 4

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

1. Setup costs of ₹ 5,00,000 to install machinery in the new location.
2. Rent of ₹ 15,00,000
3. Removal costs of ₹ 3,00,000 to transport the machinery from the old location to the temporary location.

Can these costs be capitalised into the cost of the new building?

Solution

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

Illustration 5 (Capitalisation of directly attributable costs)

Entity A, which operates a major chain of supermarkets, has acquired a new store location. The new location requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the supermarket will be closed.

Management has prepared the budget for this period including expenditure related to construction and remodelling costs, salaries of staff who will be preparing the store before its opening and related utilities costs. What will be the treatment of such expenditures?

Solution

Management should capitalise the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner

intended by management. The supermarket cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset.

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

Illustration 6 (Operating costs incurred in the start-up period)

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

Solution

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

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

C. Decommissioning, Restoration and similar Liabilities:

Initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as 'Decommissioning, Restoration and similar Liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Exception: *An enterprise applies AS 2 (Revised) "Valuation of Inventories", to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.*

Note: The obligations for costs accounted for in accordance with AS 2 (Revised) or AS 10 (Revised) are recognised and measured in accordance with AS 29 (Revised) "Provisions, Contingent Liabilities and Contingent Assets".

COST OF A SELF-CONSTRUCTED ASSET

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

1. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale. Therefore, any internal profits are eliminated in arriving at such costs.
2. Cost of abnormal amounts of wasted material, labour, or other resources incurred in self constructing an asset is not included in the cost of the asset.

3. AS 16 on Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of PPE.
4. Bearer plants are accounted for in the same way as self-constructed items of PPE before they are in the location and condition necessary to be capable of operating in the manner intended by management.

MEASUREMENT OF COST

Cost of an item of PPE is the cash price equivalent at the recognition date.

A. If payment is deferred beyond normal credit terms:

Total payment *minus* Cash price equivalent

- is recognised as an interest expense over the period of credit
- unless such interest is capitalised in accordance with AS 16

B. PPE acquired in Exchange for a Non-monetary Asset or Assets or A combination of Monetary and Non-monetary Assets:

Cost of such an item of PPE is measured at fair value unless:

- (a) Exchange transaction lacks commercial substance; Or
- (b) Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

Note:

1. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up.
2. If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.
3. An enterprise determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:
 - (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or
 - (b) the enterprise-specific value of the portion of the operations of the enterprise affected by the transaction changes as a result of the exchange;
 - (c) and the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the enterprise-specific value of the portion of operations of the enterprise affected by the transaction should reflect post-tax cash flows. In certain cases, the result

of these analyses may be clear without an enterprise having to perform detailed calculations.

Illustration 7 (Consideration received comprising a combination of non-monetary and monetary assets)

Entity A exchanges surplus land with a book value of ₹ 10,00,000 for cash of ₹ 20,00,000 and plant and machinery valued at ₹ 25,00,000. What will be the measurement cost of the assets received?

Solution

Since the transaction has commercial substance. The plant and machinery would be recorded at ₹ 25,00,000, which is equivalent to the fair value of the land of ₹ 45,00,000 less the cash received of ₹ 20,00,000.

Illustration 8 (Exchange of assets that lack commercial substance)

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

Solution

The entity recognises the assets received at the book value of car X. Therefore, it recognises cash of ₹ 15,000 and car Y as PPE with a carrying value of ₹ 12,85,000.

C. PPE purchased for a Consolidated Price:

Where several items of PPE are purchased for a consolidated price, the consideration is apportioned to the various items on the basis of their respective fair values at the date of acquisition.

Note: In case the fair values of the items acquired cannot be measured reliably, these values are estimated on a fair basis as determined by competent valuers.

D. PPE held by a lessee under a Finance Lease:

The cost of an item of PPE held by a lessee under a finance lease is determined in accordance with AS 19 (Leases).

E. Government Grant related to PPE:

The carrying amount of an item of PPE may be reduced by government grants in accordance with AS 12 (Accounting for Government Grants).

MEASUREMENT AFTER RECOGNITION

An enterprise should choose

- Either **Cost model**,
- Or **Revaluation model**

as its accounting policy and should apply that policy to an entire **class of PPE**.

Class of PPE: A class of PPE is a grouping of assets of a **similar nature and use** in operations of an enterprise.

Examples of separate classes:

- (a) Land
- (b) Land and Buildings
- (c) Machinery
- (d) Ships
- (e) Aircraft
- (f) Motor Vehicles
- (g) Furniture and Fixtures
- (h) Office Equipment
- (i) Bearer plants

COST MODEL

After recognition as an asset, an item of PPE should be carried at:

Cost- Any Accumulated Depreciation- Any Accumulated Impairment losses

REVALUATION MODEL

After recognition as an asset, an item of PPE whose fair value can be measured reliably should be carried at a revalued amount.

Fair value at the date of the revaluation	-
Less: Any subsequent accumulated depreciation	(-)
Less: Any subsequent accumulated impairment losses	<u>(-)</u>
Carrying value	<u>≡</u>

Revaluation for entire class of PPE

If an item of PPE is revalued, the entire class of PPE to which that asset belongs should be revalued.

Reason:

The items within a class of PPE are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the Financial Statements that are a mixture of costs and values as at different dates.

Illustration 9 (Revaluation on a class by class basis)

Entity A is a large manufacturing group. It owns a number of industrial buildings, such as factories and warehouses and office buildings in several capital cities. The industrial buildings are located in industrial zones, whereas the office buildings are in central business districts of the cities. Entity A's management want to apply the revaluation model as per AS 10 (Revised) to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings.

State whether this is acceptable under AS 10 (Revised) or not with reasons?

Solution

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

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement.

However, all properties within the class of office buildings must be carried at revalued amount.

Frequency of Revaluations

Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using Fair value at the Balance Sheet date.

The frequency of revaluations depends upon the changes in fair values of the items of PPE being revalued.

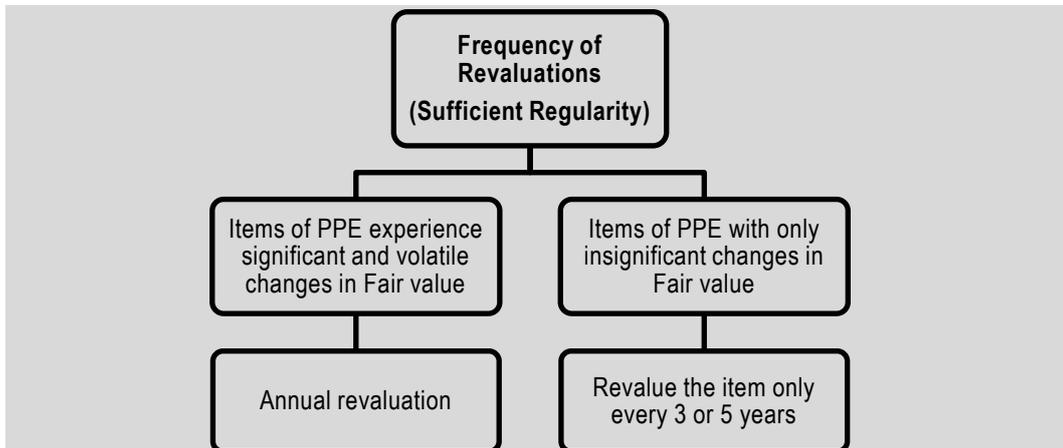
When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required.

A. Items of PPE experience significant and volatile changes in Fair value

Annual revaluation should be done.

B. Items of PPE with only insignificant changes in Fair value

Revaluation should be done at an interval of 3 or 5 years.



Determination of Fair Value

Fair value of items of PPE is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers.

If there is no market-based evidence of fair value because of the specialised nature of the item of PPE and the item is rarely sold, except as part of a continuing business, an enterprise may need to estimate fair value using an income approach.

Example:

Based on

- Discounted cash flow projections, Or
- A depreciated replacement cost approach

Which aims at making a **realistic estimate of the current cost** of acquiring or constructing an item that has the same service potential as the existing item.

Accounting Treatment of Revaluations

When an item of PPE is revalued, the carrying amount of that asset is adjusted to the revalued amount.

At the date of the revaluation, the asset is treated in one of the following ways:

A. **Technique 1:** Gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset.

Gross carrying amount

- May be restated by reference to observable market data, or
- May be restated proportionately to the change in the carrying amount.

Accumulated depreciation at the date of the revaluation is

- Adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses

Case Study on Technique I

PPE is revalued to ₹ 1,500 consisting of ₹ 2,500 Gross cost and ₹ 1,000 Depreciation based on observable market data.

Details of the PPE before and after revaluation are as follows:

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600
Fair Value			1,500
Revaluation Gain			900
Gain allocated proportionately to cost and depreciation	1,500	600	900
PPE after revaluation	2,500	1,000	1,500

The increase on revaluation is ₹ 900 (i.e., ₹ 1,500 – ₹ 600).

B. Technique 2: Accumulated depreciation is eliminated against the Gross Carrying amount of the asset

Case Study on Technique II

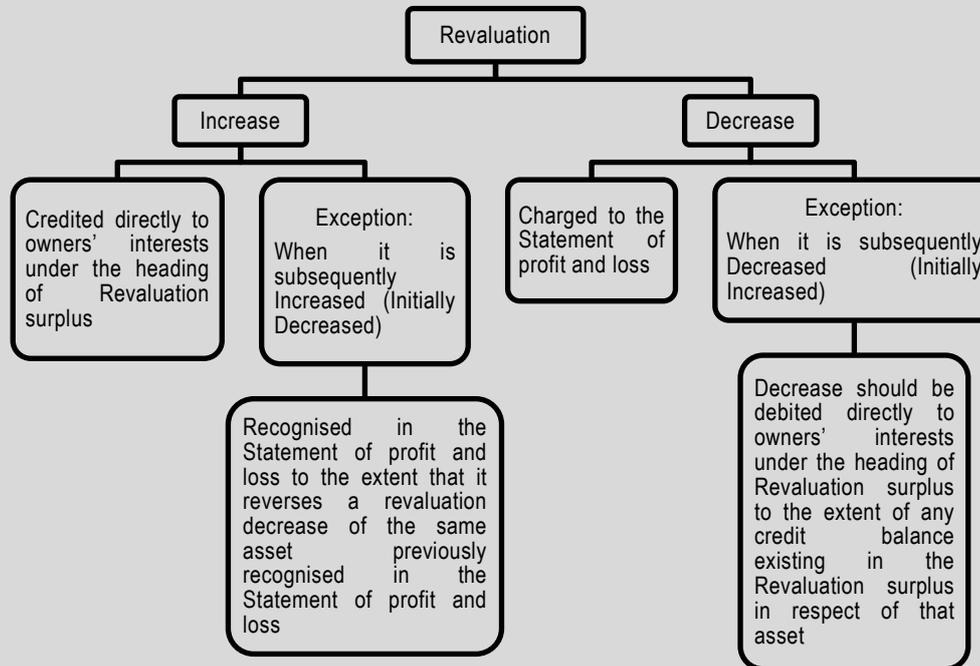
(Taking the information given in the above Example)

Details of the PPE before and after revaluation are as follows:

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600
PPE after revaluation	1,500		1,500
Revaluation gain	500	400	

The increase on revaluation is ₹ 900 (i.e., ₹ 500 + ₹ 400).

Revaluation – Increase or Decrease



Treatment of Revaluation Surplus

The revaluation surplus included in owners' interests in respect of an item of PPE may be transferred to the Revenue Reserves when the asset is derecognised.

Case I : When whole surplus is transferred:

When the asset is:

- Retired; Or
- Disposed of

Case II : Some of the surplus may be transferred as the asset is used by an enterprise:

In such a case, the amount of the surplus transferred would be:

Depreciation (based on Revalued Carrying amount) – Depreciation (based on Original Cost)

Transfers from Revaluation Surplus to the Revenue Reserves are not made through the Statement of Profit and Loss.

DEPRECIATION

Component Method of Depreciation:

Each part of an item of PPE with a cost that is significant in relation to the total cost of the item should be depreciated separately.

Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

Is Grouping of Components possible?

Yes.

A significant part of an item of PPE may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

Accounting Treatment:

Depreciation charge for each period should be recognised in the Statement of Profit and Loss unless it is included in the carrying amount of another asset.

Examples on Exception:

AS 2 (Revised): Depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories as per AS 2 (Revised).

AS 26: Depreciation of PPE used for development activities may be included in the cost of an intangible asset recognised in accordance with AS 26 on Intangible Assets.

DEPRECIABLE AMOUNT AND DEPRECIATION PERIOD

What is “Depreciable Amount”?

Depreciable amount is:

Cost of an asset (or other amount substituted for cost i.e. revalued amount) -Residual value

The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

Illustration 10

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

Solution

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

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

Review of Residual Value and Useful Life of an Asset

Residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be

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accounted for as a change in an accounting estimate in accordance with AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

Illustration 11 (Change in estimate of useful life)

Entity A purchased an asset on 1st January 2013 for ₹ 1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.

On 1st January 2017, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years.

Calculate the amount of depreciation for each year, if company charges depreciation on Straight Line basis.

Solution

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

On 1st January 2017, the asset's net book value is [1,00,000 – (10,000 x 4)] ₹ 60,000.

The remaining useful life is 4 years.

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

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

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

Commencement of period for charging Depreciation

Depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management.

Illustration 12

Entity B constructs a machine for its own use. Construction is completed on 1st November 2016 but the company does not begin using the machine until 1st March 2017. Comment

Solution

The entity should begin charging depreciation from the date the machine is ready for use – that is, 1st November 2016. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

Cessation of Depreciation

I. Depreciation ceases to be charged when asset's residual value exceeds its carrying amount

The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

Illustration 13 (Depreciation where residual value is the same as or close to Original cost)

A property costing ₹ 10,00,000 is bought in 2016. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years.

The estimated residual value in 20 years' time, based on 2016 prices, is:

Case (a) ₹ 10,00,000

Case (b) ₹ 9,00,000.

Calculate the amount of depreciation.

Solution

Case (a)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost.

There is, therefore, no depreciable amount and depreciation is correctly zero.

Case (b)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will be ₹ 9,00,000 and the depreciable amount is, therefore, ₹ 1,00,000.

Annual depreciation (on a straight line basis) will be ₹ 5,000 $[(10,00,000 - 9,00,000) \div 20]$.

II. Depreciation of an asset ceases at the earlier of:

- The date that the asset is retired from active use and is held for disposal, and
- The date that the asset is derecognised

Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated.

However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

Land and Buildings

Land and buildings are separable assets and are accounted for separately, even when they are acquired together.

A. **Land:** Land has an unlimited useful life and therefore is not depreciated.

Exceptions: Quarries and sites used for landfill.

Depreciation on Land:

I. **If land itself has a limited useful life:**

It is depreciated in a manner that reflects the benefits to be derived from it.

- II. If the cost of land includes the costs of site dismantlement, removal and restoration:

That portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.

B. Buildings:

Buildings have a limited useful life and therefore are depreciable assets.

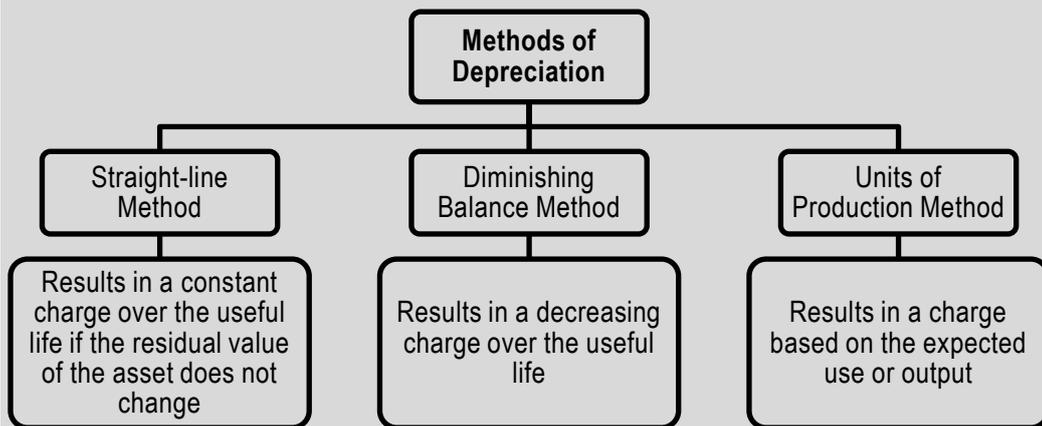
An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

Depreciation Method

The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise.

The method selected is applied consistently from period to period unless:

- There is a change in the expected pattern of consumption of those future economic benefits; Or
- That the method is changed in accordance with the statute to best reflect the way the asset is consumed.



Review of Depreciation Method:

The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern.

Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

Depreciation Method based on Revenue:

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate.

Illustration 14 (Determination of appropriate Depreciation Method)

Entity B manufactures industrial chemicals and uses blending machines in the production process. The output of the blending machines is consistent from year to year and they can be used for different products.

However, maintenance costs increase from year to year and a new generation of machines with significant improvements over existing machines is available every 5 years. Suggest the depreciation method to the management.

Solution

The straight-line depreciation method should be adopted, because the production output is consistent from year to year.

Factors such as maintenance costs or technical obsolescence should be considered in determining the blending machines' useful life.

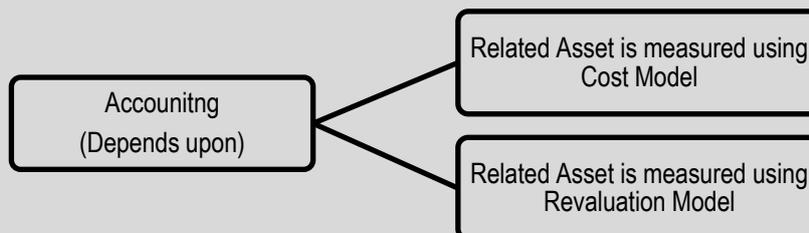
CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND OTHER LIABILITIES

The cost of PPE may undergo changes subsequent to its acquisition or construction on account of:

- Changes in Liabilities
- Price Adjustments
- Changes in Duties
- Changes in initial estimates of amounts provided for Dismantling, Removing, Restoration, and
- Similar factors

The above are included in the cost of the asset.

Accounting for the above changes:



A. If the related asset is measured using the Cost model:

Changes in the Liability should be added to, or deducted from, the cost of the related asset in the current period

Note: Amount deducted from the cost of the asset should not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognised immediately in the Statement of Profit and Loss.

If the adjustment results in an addition to the cost of an asset:

- Enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable.

Note: If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with applicable Accounting standards.

B. If the related asset is measured using the Revaluation model:

Changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:

(i) Decrease in the liability credited directly to revaluation surplus in the owners' interest

Exception:

It should be recognised in the Statement of Profit and Loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in the Statement of Profit and Loss

Note: In the event that a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess should be recognised immediately in the Statement of Profit and Loss.

(ii) Increase in the liability should be recognised in the Statement of Profit and Loss

Exception:

It should be debited directly to Revaluation surplus in the owners' interest to the extent of any credit balance existing in the Revaluation surplus in respect of that asset

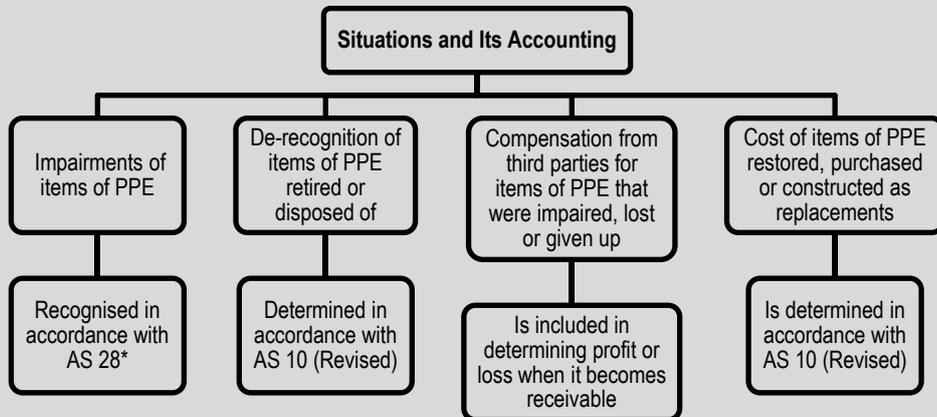
Caution:

A change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

What happens if the related asset has reached the end of its useful life?

All subsequent changes in the liability should be recognised in the Statement of Profit and Loss as they occur.

Note: This applies under both the cost model and the revaluation model.



*Students may note that AS 28 is not covered in syllabus of Intermediate paper 1 Accounting.

Illustration 15 (Gain on replacement of Insured Assets)

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

Solution

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

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

RETIREMENTS

Items of PPE retired from active use and held for disposal should be stated at the lower of:

- Carrying Amount, and
- Net Realisable Value

Note: Any write-down in this regard should be recognised immediately in the Statement of Profit and Loss.

DE-RECOGNITION

The carrying amount of an item of PPE should be derecognised:

- On disposal
 - By sale
 - By entering into a finance lease, or
 - By donation, Or
- When no future economic benefits are expected from its use or disposal

Accounting Treatment:

Gain or loss arising from de-recognition of an item of PPE should be included in the Statement of Profit and Loss when the item is derecognised unless AS 19 on Leases, requires otherwise on a sale and leaseback (AS 19 on Leases, applies to disposal by a sale and leaseback.)

Where,

Gain or loss arising from de-recognition of an item of PPE
= Net disposal proceeds (if any) - Carrying Amount of the item

Note: Gains should not be classified as revenue, as defined in AS9 Revenue Recognition'.

Exception:

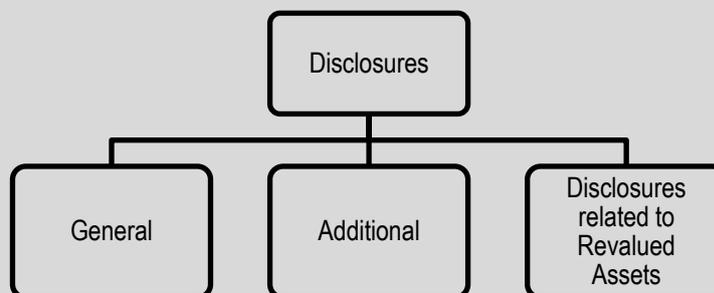
An enterprise that in the course of its ordinary activities, routinely sells items of PPE that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale.

The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9 on Revenue Recognition.

Determining the date of disposal of an item:

An enterprise applies the criteria in AS 9 for recognising revenue from the sale of goods.

DISCLOSURE



General Disclosures:

The financial statements should disclose, for each class of PPE:

- (a) The measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;
- (b) The depreciation methods used;
- (c) The useful lives or the depreciation rates used.

In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact;

- (d) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
- (e) A reconciliation of the carrying amount at the beginning and end of the period showing:
 - (i) additions
 - (ii) assets retired from active use and held for disposal
 - (iii) acquisitions through business combinations
 - (iv) increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 28
 - (v) impairment losses recognised in the statement of profit and loss in accordance with AS 28
 - (vi) impairment losses reversed in the statement of profit and loss in accordance with AS 28
 - (vii) depreciation
 - (viii) net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11
 - (ix) other changes

Additional Disclosures:

The financial statements should also disclose:

- (a) The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
- (b) The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;
- (c) The amount of contractual commitments for the acquisition of property, plant and equipment;
- (d) If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and

- (e) The amount of assets retired from active use and held for disposal.

Disclosures related to Revalued Assets:

If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

- (a) The effective date of the revaluation;
- (b) Whether an independent valuer was involved;
- (c) The methods and significant assumptions applied in estimating fair values of the items;
- (d) The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and
- (e) The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

TRANSITIONAL PROVISIONS

Previously Recognised Revenue Expenditure

Where an entity has in past recognised an expenditure in the Statement of Profit and Loss which is eligible to be included as a part of the cost of a project for construction of PPE in accordance with the requirements of this standard:

- It may do so retrospectively for such a project.

Note: The effect of such retrospective application, should be recognised net-of-tax in Revenue reserves.

PPE acquired in Exchange of Assets

The requirements of AS 10 (Revised) regarding the initial measurement of an item of PPE acquired in an exchange of assets transaction should be applied prospectively only to transactions entered into after this Standard becomes mandatory.

Spare parts

On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS 2 (Revised), and are now required to be capitalised in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts.

Note: The spare parts so capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.

Revaluations

The requirements of AS 10 (Revised) regarding the revaluation model should be applied prospectively.

In case, on the date of this Standard becoming mandatory, an enterprise does not adopt the revaluation model as its accounting policy but the carrying amount of items of PPE reflects any previous revaluation it should adjust the amount outstanding in the Revaluation reserve against the carrying amount of that item.

Note: The carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as Revaluation reserve over the carrying amount of that item should be adjusted in Revenue reserves.

2.4.7 Accounting for Investments (AS 13)

This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

This Statement does not deal with:

- a. The bases for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.
- b. Operating or finance leases.
- c. Investments of retirement benefit plans and life insurance enterprises and
- d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 2013.

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

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

Forms of Investments

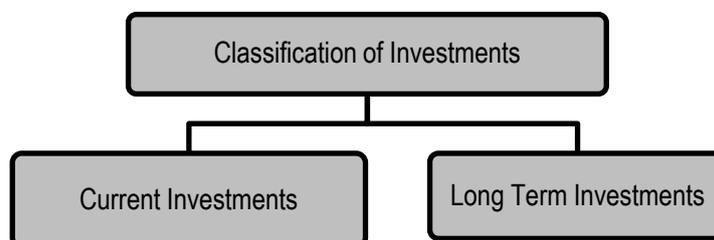
Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'.

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings).

For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

Classification of Investments



A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

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

Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties.

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

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income.

If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value. Valuation of current investments on overall basis is not considered appropriate. The more prudent and appropriate method is to carry investments individually at the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the Profit & Loss Statement.

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

Investment Properties

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

An investment property is accounted for in accordance with cost model as prescribed in AS 10, 'Property, Plant and Equipment'. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

Reclassification of Investments

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

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

Disclosure

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

- a. The accounting policies for the determination of carrying amount of investments.
- b. The amounts included in profit and loss statement for:
 - i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.

- ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.
- iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.
- c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.
- d. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments.
- e. Other disclosures as specifically required by the relevant statute governing the enterprise.

Example 1

X Ltd. on 1-1-2014 had made an investment of ₹ 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realizable value of all such investment on 31-3-2014 became ₹ 200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is permanent in nature. How will you recognize the reduction in financial statements for the year ended on 31-3-2014?

Solution

X Ltd. invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.2014 to 31.3.2014), AS 13 lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realizable value of all such investments on 31.3.2014 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

As per AS 13, 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realizable value i.e. at ₹ 100 lakhs. The reduction of ₹ 200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Ltd. lost a case of copyright which drastically reduced the realisable value of its

shares to one third which is quite a substantial figure. Losing the case of copyright may affect the business and the performance of the company in long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by ₹ 200 lakhs and show the investments at ₹ 100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of ₹ 200 lakhs in the carrying value of long term investment will be charged to the Statement of profit and loss.

Note: Students are advised to refer 'chapter 12' for problems based on practical application of AS 13.

2.4.8 Accounting for Amalgamations (AS 14)

This standard is mandatory in nature. It deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

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

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

Transferor company means the company which is amalgamated into another company.

Transferee company means the company into which a transferor company is amalgamated.

Types of Amalgamations

Amalgamations fall into two broad categories:

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

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

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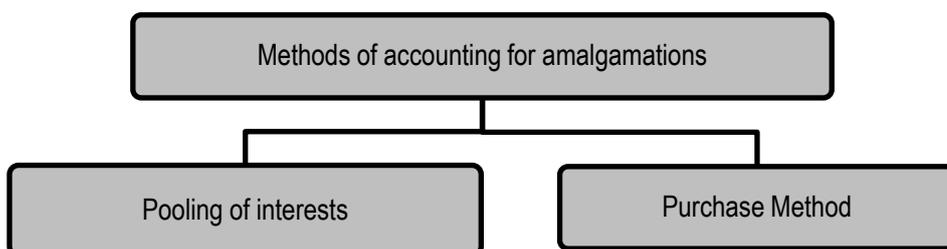
is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

- 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 for Amalgamations

There are two main methods of accounting for amalgamations, viz.,



Pooling of interests

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

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

The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

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

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

Example

A Ltd. take over B Ltd. on April 01, 2015 and discharges consideration for the business as follows:

- (i) *Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.*
- (ii) *Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders (₹ 1,70,000) of B Ltd. at a premium of 10%.*
- (iii) *It is agreed that the debentures of B Ltd. (₹ 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.*

Solution:

Particulars	₹	₹
Equity Shares (42,000 x 10)		4,20,000
Preference Share Capital	1,70,000	
Add : Premium on Redemption	<u>17,000</u>	<u>1,87,000</u>
Purchase Consideration		<u>6,07,000</u>

Treatment of Reserves on Amalgamation

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

Adjustments to reserves - Amalgamation in the Nature of Merger

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

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

Adjustments to reserves - Amalgamation in the Nature of Purchase

If the amalgamation is an 'amalgamation in the nature of purchase', the amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

Though, normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. ***In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.***

The Standard gives a title, which reads as "Reserve". This gives rise to following requirements.

- 1. The corresponding debit is "also" to a Reserve Account***
- 2. That Reserve account will show a negative balance***
- 3. But it has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over".***

So the presentation will be as follows:

Notes to Accounts for "Reserves and Surplus"

<i>Description</i>	<i>Amount (Current year)</i>	<i>Amount (Previous Year)</i>
<i>Statutory Reserve (taken over from transferor company)</i>		
<i>General Reserve</i>		
<i>Profit and Loss or Retained Earnings</i>		
<i>Amalgamation Adjustment Reserve (negative balance)</i>	<i>(--)</i>	<i>(--)</i>

Treatment of Goodwill Arising on Amalgamation

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

Illustration

The following are the summarised balance sheets of A Ltd. and B Ltd. as on March 31, 2015:

Liabilities	A Ltd. (₹)	B Ltd. (₹)
Equity Shares, ₹ 10 each, fully paid up	7,20,000	3,00,000
14% Preference Share Capital, ₹ 100 each, fully paid up	1,50,000	1,70,000
Securities Premium	1,50,000	
Capital Reserve		13,000
General Reserve	80,000	45,000
Export Profit Reserve		20,000
Profit and Loss Account	75,000	40,000
Workmen Compensation Fund		3,000
13% Debentures, ₹ 100 each, fully paid up	1,00,000	50,000
Trade payables	1,15,000	35,000
Provision for Taxation	15,000	10,000
	14,05,000	6,86,000

Assets		
Goodwill	2,00,000	60,000
Land and Buildings	2,50,000	
Plant and Machinery	3,25,000	2,70,000
Furniture and Fixtures	57,000	95,000
Inventory	2,15,000	1,75,000
Trade receivables	72,000	30,000
Income Tax Refund Claim		6,000
Cash at Bank	2,16,000	50,000
Cash in Hand	70,000	
	14,05,000	6,86,000

A Ltd. take over B Ltd. on April 01, 2015 and discharges consideration for the business as follows:

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- Issued 42,000 fully paid equity shares of ₹ 10 each at par to the equity shareholders of B Ltd.
- Issued fully paid up 15% preference shares of ₹ 100 each to discharge the preference shareholders of B Ltd. at a premium of 10%.
- It is agreed that the debentures of B Ltd. will be converted into equal number and amount of 13% debentures of A Ltd.
- The Statutory Reserve of B Ltd. is to be maintained for two more years.
- Expenses of amalgamation amounting to ₹ 15,000 are borne by A Ltd.

Solution

Since all the five conditions are satisfied, it is amalgamation in the nature of merger. Following are the journal entries in the books of A Ltd. and the calculation of the Purchase Consideration.

Particulars		Dr. (₹)	Cr. (₹)
Goodwill Account	Dr.	60,000	
Plant & Machinery Account	Dr.	2,70,000	
Furniture & Fixtures Account	Dr.	95,000	
Inventory Account	Dr.	1,75,000	
Trade receivables Account	Dr.	30,000	
IT Refund Account	Dr.	6,000	
Bank Account	Dr.	50,000	
General Reserve Account (Balancing Figure)	Dr.	52,000	
			13,000
			20,000
			3,000
			50,000
			35,000
			10,000
			6,07,000
Business Purchase Account	Dr.	6,07,000	
			6,07,000
B Ltd. Liquidator Account	Dr.	6,07,000	
			4,20,000
			1,87,000
13% Debentures Account (In B Ltd.)	Dr.	50,000	
			50,000

If we consider that the fifth point i.e. business of B Ltd. was not carried on by A Ltd. then it will be Amalgamation in the nature of Purchase and the journal entries in the books of A Ltd. will be as follow:

<i>Particulars</i>		Dr. (₹)	Cr. (₹)
Goodwill Account (Balancing Figure)	Dr.	76,000	
Plant & Machinery Account	Dr.	2,70,000	
Furniture & Fixtures Account	Dr.	95,000	
Stock Account	Dr.	1,75,000	
Debtors Account	Dr.	30,000	
IT Refund Account	Dr.	6,000	
Bank Account	Dr.	50,000	
To 13% Debentures Account			50,000
To Creditors Account			35,000
To Provision for Tax Account			10,000
To Business Purchase Account			6,07,000
Business Purchase Account Dr.		6,07,000	
To B Ltd. Liquidator Account			6,07,000
B Ltd. Liquidator Account	Dr.	6,07,000	
To Equity Share Capital Account			4,20,000
To Preference Share Capital			1,87,000
13% Debentures Account (In B Ltd.)	Dr.	50,000	
To 13% Debentures Account (In A Ltd.)			50,000
Profit and Loss A/c	Dr.	15,000	
To Bank Account			15,000
Amalgamation Adjustment Reserve Account	Dr.	20,000	
To Export Profit Reserve Account			20,000

Disclosure

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;
- The method of accounting used to reflect the amalgamation; and

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- d. Particulars of the scheme sanctioned under a statute.

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

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

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

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

Note: For problems based on practical application of AS 14, students are advised to refer 'chapter 6' of the study material.

Miscellaneous Illustrations

AS 1 Disclosure of Accounting Policies

Illustration 1

ABC Ltd. was making provision for non-moving stocks based on no issues for the last 12 months up to 31.3.2015.

The company wants to provide during the year ending 31.3.2015 based on technical evaluation:

<i>Total value of stock</i>	<i>₹ 100 lakhs</i>
<i>Provision required based on 12 months issue</i>	<i>₹ 3.5 lakhs</i>
<i>Provision required based on technical evaluation</i>	<i>₹ 2.5 lakhs</i>

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

Solution

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

stocks may be said as accounting policy but the basis for making provision will not constitute accounting policy. It will be considered as an accounting estimate. Further, the method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of stock, the change in the amount of required provision of non-moving stock from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2014-15:

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

Illustration 2

Jagannath Ltd. had made a rights issue of shares in 2012. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2014. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:

- (i) *Value year-end inventory at works cost (₹ 50 crores) instead of the hitherto method of valuation of inventory at prime cost (₹ 30 crores).*
- (ii) *Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at ₹ 27 crores is lower than the amount of ₹ 45 crores which would have been provided had the old method been followed, by ₹ 18 cores.*
- (iii) *Not to provide for “after sales expenses” during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of “matching of costs against revenue” and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.*
- (iv) *Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being ₹ 10 crores.*

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2013-2014.

Solution

As per AS 1, any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be

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disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. Accordingly, the notes on accounts should properly disclose the change and its effect.

Notes on Accounts:

- (i) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ₹ 50 crores and the profit for the year is increased by ₹ 20 crores.
- (ii) In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at ₹ 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by ₹ 18 crores. To that extent, the profit for the year is increased.
- (iii) So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 12 crores than would have been the case if the old policy were to continue.
- (iv) The company has decided to provide ₹ 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹ 10 crores.

AS 2 Valuation of Inventories

Illustration 3

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2014-15, the Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

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

What will be the value of Closing Stock?

Solution

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

Items	Historical Cost (₹ in lakhs)	Net Realisable Value (₹ in lakhs)	Valuation of closing stock (₹ in lakhs)
A	40	28	28
B	32	32	32
C	<u>16</u>	<u>24</u>	<u>16</u>
	<u>88</u>	<u>84</u>	<u>76</u>

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

Illustration 4

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

- 400 coats, which had cost ₹ 80 each and normally sold for ₹ 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.
- 800 skirts, which had cost ₹ 20 each. These too were found to be defective. Remedial work in April cost ₹ 5 per skirt, and selling expenses for the batch totaled ₹ 800. They were sold for ₹ 28 each.

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

Solution**Valuation of Closing Stock**

Particulars	₹	₹
Closing Stock at cost		2,84,700
Less : Cost of 400 coats (400 x 80)	32,000	
Less: Net Realisable Value [400 x (75 – 5% of ₹75)]	<u>28,500</u>	<u>3,500</u>
Value of Closing Stock		<u>2,81,200</u>

Note: There is no adjustment for skirts because for skirts were sold at above cost.

Illustration 5

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

<u>Raw material X</u>	
Closing balance	500 units
	<u>₹ per unit</u>
Cost price including GST	200
Input tax credit receivable	10
Freight inward	20
Unloading charges	10
Replacement cost	150
<u>Finished goods Y</u>	
Closing Balance	1200 units
	<u>₹ per unit</u>
Material consumed	220
Direct labour	60
Direct overhead	40

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

Calculate the value of the closing stock, when

- (i) Net Realizable Value of the Finished Goods Y is ₹ 400.
- (ii) Net Realizable Value of the Finished Goods Y is ₹ 300.

Solution

Statement showing valuation of Raw Material and Finished Goods at cost

<u>Raw Material X</u>	₹
Cost Price	200
Less: Input tax credit	<u>(10)</u>
	190
Add: Freight Inward	20
Unloading charges	<u>10</u>
Cost	<u>220</u>

<i>Finished goods Y</i>	₹
Materials consumed	220
Direct labour	60
Direct overhead	40
Fixed overheads (2,00,000/20,000)	<u>10</u>
Cost	<u>330</u>

- (i) When Net Realisable Value (NRV) of the Finished Goods Y is ₹ 400

NRV is greater than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material and Finished Goods will be valued at cost

Accordingly, value of closing stock will be:

	Qty	Rate	Amount (₹)
Raw Material X	500	220	1,10,000
Finished Goods Y	1,200	330	<u>3,96,000</u>
Total cost of closing stock			<u>5,06,000</u>

- (ii) When Net Realisable Value of the Finished Goods Y is ₹ 300

NRV is less than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material is to be valued at replacement cost and Finished Goods are to be valued at NRV.

Accordingly, value of closing stock will be:

	Qty	Rate	Amount (₹)
Raw Material X	500	150	75,000
Finished Goods Y	1,200	300	<u>3,60,000</u>
Total cost of closing stock			<u>4,35,000</u>

Note: It has been assumed that Raw Material X is used for production of Finished Goods Y.

AS 3 Cash Flow Statements

Illustration 6

Classify the following activities as (1) Operating Activities, (2) Investing Activities, (3) Financing Activities:

- Purchase of Machinery.
- Proceeds from issuance of equity share capital.

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- c. Cash Sales.
- d. Proceeds from long-term borrowings.
- e. Proceeds from Debtors.
- f. Brokerage paid on purchase of investments.

Solution

As per para 5 of AS 3 (Revised) "Cash Flow Statements",

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

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

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

Thus, the classification will be done as:

Operating Activities: c, e,

Investing Activities: a, f,

Financing Activities: b, d.

AS 7 Construction Contracts

Illustration 7

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2013.

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

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 (Revised) issued by your institute.

Solution

(a) Amount of foreseeable loss	(₹ in lakhs)
Total cost of construction (500 + 105 + 495)	1,100

Less: Total contract price	(1,000)
Total foreseeable loss to be recognized as expense	<u>100</u>

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

(b) <i>Contract work-in-progress i.e. cost incurred to date are ₹ 605 lakhs</i>	<i>(₹ in lakhs)</i>
Work certified	500
Work not certified	<u>105</u>
	<u>605</u>
This is 55% ($605/1,100 \times 100$) of total costs of construction.	

(c) Proportion of total contract value recognised as revenue as per para 21 of AS 7 (Revised).

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

(d) Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)

$$= [605 + \text{Nil} - 100 - (400 + 140)] \text{ ₹ in lakhs}$$

$$= [605 - 100 - 540] \text{ ₹ in lakhs}$$

Amount due to customers = ₹ 35 lakhs

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

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

	₹ in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognized losses	(100)
Progress billings (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

Illustration 8

On 1st December, 2014, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2015 the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. Calculate total estimated loss on contract and what amount should be charged

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to revenue in the final accounts for the year ended 31st March, 2015 as per provisions of Accounting Standard 7 (Revised)?

Solution

Calculation of estimated total loss and amount charged to revenue

	₹
Cost incurred till 31 st March, 2015	64,99,000
Prudent estimate of additional cost for completion	<u>32,01,000</u>
Total cost of construction	97,00,000
Less: Contract price	<u>(85,00,000)</u>
Total foreseeable loss	<u>12,00,000</u>

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

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

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

$$= 67\% \text{ of ₹ } 85,00,000 = \text{₹ } 56,95,000.$$

AS 9 Revenue Recognition

Illustration 9

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2014-15.

You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution

As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

- (i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.
- (ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 10

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2013-2014 the company wants to recognise the entire interest receivable. Do you agree?

Solution

As per para 9.2 of AS 9 on Revenue Recognition, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

Thus, SCL Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstandings is also an estimate and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

AS 10 Property, Plant and Equipment**Illustration 11**

ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

Cost of the plant (cost per supplier's invoice plus taxes)	₹ 25,00,000
Initial delivery and handling costs	₹ 2,00,000
Cost of site preparation	₹ 6,00,000
Consultants used for advice on the acquisition of the plant	₹ 7,00,000
Interest charges paid to supplier of plant for deferred credit	₹ 2,00,000
Estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
Operating losses before commercial production	₹ 4,00,000

Please advise ABC Ltd. on the costs that can be capitalised in accordance with AS 10 (Revised).

Solution

According to AS 10 (Revised), these costs can be capitalized:

Cost of the plant	₹ 25,00,000
Initial delivery and handling costs	₹ 2,00,000
Cost of site preparation	₹ 6,00,000
Consultants' fees	₹ 7,00,000

Estimated dismantling costs to be incurred after 7 years	<u>₹ 3,00,000</u>
	<u>₹ 43,00,000</u>

Note: Interest charges paid on “Deferred credit terms” to the supplier of the plant (not a qualifying asset) of ₹ 2,00,000 and operating losses before commercial production amounting to ₹ 4,00,000 are not regarded as directly attributable costs and thus cannot be capitalised. They should be written off to the Statement of Profit and Loss in the period they are incurred.

Illustration 12

In the year 2016-17, an entity has acquired a new freehold building with a useful life of 50 years for ₹ 90,00,000. The entity desires to calculate the depreciation charge per annum using a straight-line method. It has identified the following components (with no residual value of lifts & fixtures at the end of their useful life) as follows:

Component	Useful life (Years)	Cost
Land	Infinite	₹ 20,00,000
Roof	25	₹ 10,00,000
Lifts	20	₹ 5,00,000
Fixtures	10	₹ 5,00,000
Remainder of building	50	<u>₹ 50,00,000</u>
		<u>₹ 90,00,000</u>

Calculate depreciation for the year 2016-17 as per componentization method.

Solution

Statement showing amount of depreciation as per Componentization Method

Component	Depreciation (Per annum) (₹)
Land	Nil
Roof	40,000
Lifts	25,000
Fixtures	50,000
Remainder of Building	<u>1,00,000</u>
	<u>2,15,000</u>

Note: When the roof requires replacement at the end of its useful life the carrying amount will be nil. The cost of replacing the roof should be recognised as a new component.

AS 13 Accounting for Investments

Illustration 13

While preparing the financial statements of R Ltd. for the year ended 31st March, 2015, you come to know that an unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2015 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How you would deal with this in the financial statements?

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2015 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2015.

Illustration 14

Saksham Ltd. wants to re-classify its Investment in accordance with AS 13. Decide on the treatment to be given in each of the following cases assuming that the market value has been determined in an arm's length transaction between knowledgeable and willing buyer and seller:

- (i) A portion of Current Investments purchased for ₹ 10 lakhs to be reclassified as long-term Investments, as the company has decided to retain them. The market value as on the date of Balance Sheet was ₹ 12 lakhs.*
- (ii) Another portion of Current Investments purchased for ₹ 8 lakhs has to be re classified as Long-term Investments. The market value of these investments as on the date of Balance Sheet was ₹ 5 lakhs.*

Solution

As per para 24 of AS 13 'Accounting for Investments', where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

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- (i) In the first case, the market value of the investment is ₹ 12 lakhs, which is higher than its cost i.e. ₹ 10 lakhs. Therefore, the transfer to long term investments should be made at cost i.e. ₹ 10 lakhs.
- (ii) In the second case, the market value of the investment is ₹ 5 lakhs, which is lower than its cost i.e. ₹ 8 lakhs. Therefore, the transfer to long term investments should be made in the books at the market value i.e. ₹ 5 lakhs. The loss of ₹ 3 (8 – 5) lakhs should be charged to profit and loss account.

Reference: The students are advised to refer the full text of AS 1, 2, 3, 7, 9, 10, 13 and 14 given in Appendix I.