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Accounting Standards

BASIC CONCEPTS

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. Accounting Standards 4, 5, 11, 12, 16, 19, 20, 26, 29 are covered in this paper.

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

Question 1

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

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

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

Answer

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

Suit filed against the company being a contingent liability must be disclosed with the nature of contingency, an estimate of the financial effect and uncertainties which may affect the future outcome must be disclosed as per para 16 of AS 4.

Question 2

MEC Limited could not recover an amount of ₹ 8 lakhs from a debtor. The company is aware that the debtor is in great financial difficulty. The accounts of the company for the year ended 31-3-2011 were finalized by making a provision @ 25% of the amount due from that debtor. In May 2011, the debtor became bankrupt and nothing is recoverable from him. Do you advise the company to provide for the entire loss of ₹ 8 lakhs in books of account for the year ended 31-3-2011?

Answer

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

As per the information given in the question, the company was aware that the debtor was already in a great financial difficulty at the time of closing of accounts. Bankruptcy of the debtor in May 2011 is only an additional information to the condition existing on the balance sheet date. Also the effect of a debtor becoming bankrupt is material as total amount of ₹ 8 lakhs will be a loss to the company. Therefore, the company is advised to provide for the entire amount of ₹ 8 lakhs in the books of account for the year ended 31st March, 2011.

Question 3

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

Answer

The loss due to break out of fire is an example of event occurring after the balance sheet date. The event being in the nature of a fire which is unpredictable does not relate to conditions existing at the balance sheet date. It has not affected the financial position as on the date of balance sheet and therefore requires no specific adjustments in the financial statements. However, paragraph 8.6 of AS 4 states that disclosure is generally made of events occurring after balance sheet date i.e. in subsequent periods that represent unusual changes affecting the existence or substratum of the enterprise after the balance sheet date. In the given case, the amount of loss of assets in a factory is material and may be considered as an event affecting the substratum of the enterprise. Hence, as recommended in paragraph 15 of AS 4, disclosure of the event should be made.

Question 4

A Company entered into an agreement to sell its immovable property to another company for ₹ 35 lakhs. The property was shown in the Balance Sheet at ₹ 7 lakhs. The agreement to sell was concluded on 15th February, 2011 and sale deed was registered on 30th April, 2011.

You are required to state, with reasons, how this event would be dealt with in the financial statements for the year ended 31st March, 2011.

Answer

According to para 13 of AS 4 “Contingencies and Events Occurring after the Balance Sheet Date”, assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date. In the given case, sale of immovable property was carried out before the closure of the books of accounts. This is clearly an event occurring after the balance sheet date but agreement to sell was effected on 15th February 2011 i.e. before the balance sheet date. Registration of the sale deed on 30th April, 2011, simply provides additional information relating to the conditions existing at the balance sheet date. Therefore, adjustment to assets for sale of immovable property is necessary in the financial statements for the year ended 31st March, 2011.

Question 5

In Raj Co. Ltd., theft of cash of ₹ 2 lakhs by the cashier in January, 2011 was detected in May, 2011. The accounts of the company were not yet approved by the Board of Directors of the company.

Whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.2011. Decide.

Answer

As per para 13 of AS 4 (revised), ‘Contingencies and Events Occurring After the Balance Sheet Date’, assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date.

Though the theft, by the cashier ₹ 2,00,000, was detected after the balance sheet date (before approval of financial statements) but it is an additional information materially affecting the determination of the cash amount relating to conditions existing at the balance sheet date. Therefore, it is necessary to make the necessary adjustments in the financial statements of the company for the year ended 31st March, 2011 for recognition of the loss amounting ₹ 2,00,000.

Question 6

A Company follows April to March as its financial year. The Company recognizes cheques dated 31st March or before, received from customers after balance sheet date, but before

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approval of financial statement by debiting 'Cheques in hand account' and crediting 'Debtors account'. The 'cheques in hand' is shown in the Balance Sheet as an item of cash and cash equivalents. All cheques in hand are presented to bank in the month of April and are also realised in the same month in normal course after deposit in the bank. State with reasons, whether the collection of cheques bearing date 31st March or before, but received after Balance Sheet date is an adjusting event and how this fact is to be disclosed by the company?

Answer

Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on the balance sheet date i.e. 31st March. Thus, the collection of cheques after balance sheet date is not an adjusting event. Cheques that are received after the balance sheet date should be accounted for in the period in which they are received even though the same may be dated 31st March or before as per AS 4 "Contingencies and Events Occurring after the Balance Sheet Date". Moreover, the collection of cheques after balance sheet date does not represent any material change affecting financial position of the enterprise on the balance sheet date, so no disclosure is necessary.

Question 7

While preparing its final accounts for the year ended 31st March 2010, a company made a provision for bad debts @ 4% of its total debtors (as per trend followed from the previous years). In the first week of March 2010, a debtor for ₹ 3,00,000 had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2010 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2010.

Answer

As per para 8 of AS 4 'Contingencies and Events Occurring After the Balance Sheet Date', adjustment to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the Balance Sheet date.

A debtor for ₹ 3,00,000 suffered heavy loss due to earthquake in the first week of March, 2010 which was not covered by insurance. This information with its implications was already known to the company. The fact that he became bankrupt in April, 2010 (after the balance sheet date) is only an additional information related to the existing condition on the balance sheet date. Accordingly, full provision for bad debts amounting ₹ 3,00,000 should be made, to cover the loss arising due to the insolvency of a debtor, in the final accounts for the year ended 31st March 2010.

Question 8

In preparing the financial statements of Lotus Limited for the year ended 31st March, 2010 you come across the following information. State with reason, how you would deal with this in the financial statements?

The company invested ₹ 50 lakhs in April, 2010 in the acquisition of another company doing similar business, the negotiations for which had just started.

Answer

As per AS 4 “Contingencies and Events Occurring after the Balance Sheet Date”, events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority* to enable users of financial statements to make proper evaluations and decisions.

The investment of ₹ 50 lakhs in April 2010 for acquisition of another company is under negotiation stage, and has not been finalized yet. On the other hand it is also not affecting the figures stated in the financial statements of 2009-10, hence the details regarding such negotiation and investment planning of ₹ 50 lakhs in April, 2010 in the acquisition of another company should be disclosed in the Directors’ Report* to enable users of financial statements to make proper evaluations and decision.

Question 9

Cashier of A-One Limited embezzled cash amounting to ₹ 6,00,000 during March, 2012 . However same comes to the notice of Company management during April, 2012 only. Financial statements of the company is not yet approved by the Board of Directors of the company. With the help of provisions of AS 4 “Contingencies and Events Occurring after the Balance Sheet Date” decide, whether the embezzlement of cash should be adjusted in the books of accounts for the year ending March, 2012?

What will be your reply, if embezzlement of cash comes to the notice of company management only after approval of financial statements by the Board of Directors of the company ?

Answer

As per para 13 of AS 4, assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date.

Though the theft, by the cashier ₹ 6,00,000, was detected after the balance sheet date (before approval of financial statements) but it is an additional information materially affecting the determination of the cash amount relating to conditions existing at the balance sheet date. Therefore, it is necessary to make the necessary adjustments in the financial statements of

**To promote transparency, Exposure Draft has recently been issued by the ICAI on Limited Revision to AS 4 “Events occurring After the Balance Sheet Date”. According to this Limited Revision, these events should be disclosed in the financial statements instead of in the report of the approving authority. However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt.*

the company for the year ended 31st March, 2012 for recognition of the loss amounting ₹ 6,00,000.

If embezzlement of cash comes to the notice of company management only after approval of financial statements by board of directors of the company, then the treatment will be done as per the provisions of AS 5. This being extra ordinary item should be disclosed in the statement of profit and loss as a part of loss for the year ending March, 2013. The nature and the amount of prior period items should be separately disclosed on the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

Question 10

Neel Limited has its corporate office in Mumbai and sells its products to stockists all over India. On 31st March, 2013, the company wants to recognize receipt of cheques bearing date 31st March, 2013 or before, as "Cheques in Hand" by reducing "Trade Receivables". The "Cheques in Hand" is shown in the Balance Sheet as an item of cash and cash equivalents. All cheques are presented to the bank in the month of April 2013 and are also realized in the same month in normal course after deposit in the bank. State with reasons, whether each of the following is an adjusting event and how this fact is to be disclosed by the company, with reference to the relevant accounting standard.

- (i) *Cheques collected by the marketing personnel of the company from the stockists on or before 31st March, 2013.*
- (ii) *Cheques sent by the stockists through courier on or before 31st March, 2013.*

Answer

- (i) Cheques collected by the marketing personnel of the company is an adjusting event as the marketing personnels are employees of the company and therefore, are representatives of the company. Handing over of cheques by the stockist to the marketing employees discharges the liability of the stockist. Therefore, cheques collected by the marketing personnel of the company on or before 31st March, 2013 require adjustment from the stockists' accounts i.e. from 'Trade Receivables A/c' even though these cheques (dated on or before 31st March, 2013) are presented in the bank in the month of April, 2013 in the normal course. Hence, collection of cheques by the marketing personnel is an adjusting event as per AS 4 'Contingencies and Events Occurring after the Balance Sheet Date'. Such 'cheques in hand' will be shown in the Balance Sheet as 'Cash and Cash equivalents' with a disclosure in the Notes to accounts about the accounting policy followed by the company for such cheques.
- (ii) Even if the cheques bear the date 31st March or before and are sent by the stockists through courier on or before 31st March, 2013, it is presumed that the cheques will be received after 31st March. Collection of cheques after 31st March, 2013 does not represent any condition existing on the balance sheet date i.e. 31st March. Thus, the collection of cheques after balance sheet date is not an adjusting event. Cheques that are received after the balance sheet date should be accounted for in the period in which they are received even though the

same may be dated 31st March or before as per AS 4. Moreover, the collection of cheques after balance sheet date does not represent any material change affecting financial position of the enterprise, so no disclosure in the Director's Report is necessary.

Question 11

State with reasons, how the following events would be dealt with in the financial statements of Pradeep Ltd. for the year ended 31st March, 2013:

- (i) *An agreement to sell a land for ₹ 30 lakh to another company was entered into on 1st March, 2013. The value of land is shown at ₹ 20 lakh in the Balance Sheet as on 31st March, 2012. However, the Sale Deed was registered on 15th April, 2013.*
- (ii) *The negotiation with another company for acquisition of its business was started on 2nd February, 2013. Pradeep Ltd. invested ₹ 40 lakh on 12th April, 2013.*

Answer

- (i) According to AS 4 "Contingencies and Events Occurring after the Balance Sheet Date", assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date.

In the given case, sale of immovable property was carried out before the closure of the books of accounts. This is clearly an event occurring after the balance sheet date but agreement to sell was effected on 1st March, 2013 i.e. before the balance sheet date. Registration of the sale deed on 15th April, 2013, simply provides additional information relating to the conditions existing at the balance sheet date. Therefore, adjustment to assets for sale of land is necessary in the financial statements of Pradeep Ltd. for the year ended 31st March, 2013.

- (ii) AS 4 (Revised) defines "Events occurring after the balance sheet date" as those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2013.

Applying provisions of the standard which clearly state that disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 40 lakhs in April, 2013 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

Question 12

In its Final Accounts for the year ended 31st March, 2014, Z Ltd. made a provision of 3% of its total debtors. On 10th March, 2014, a debtor of ₹ 5 lakhs suffered a heavy loss and became insolvent in April 2014. The loss was not insured.

State giving reasons, if the company may provide for the full loss in its accounts for the year ended 31st March, 2014.

Answer

According to para 8.2 of Accounting Standard 4 "Contingencies and Events Occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the given case, though the debtor became insolvent after balance sheet date, yet he had suffered heavy loss (not covered by the insurance), before the balance sheet date and this loss was the cause of the insolvency of the debtor.

Therefore the company must make full provision for bad debts amounting ₹ 5 lakhs in its final accounts for the year ended 31st March, 2014.

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

Question 13

When can a company change its accounting policy?

Answer

A change in accounting policy should be made in the following conditions:

- (i) If the change is required by some statute or for compliance with an Accounting Standard.
- (ii) Change would result in more appropriate presentation of the financial statement.

Change in accounting policy may have a material effect on the items of financial statements. For example, if depreciation method is changed from straight-line method to written-down value method, or if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify and disclose the effect of change on financial statement items like assets, liabilities, profit / loss.

Question 14

A limited company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2010-2011.

Subsequently on a review of the credit period allowed and financial capacity of the customers, the company decided to increase the provision to 8% on debtors as on 31.3.2011. The accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard can this revision be considered as an extraordinary item or prior period item?

Answer

As per para 21 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the preparation of financial statements involves making estimates which are based on the circumstances existing at the time when the financial statements are prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate, by its nature, does not bring the adjustment within the definitions of a prior period item or an extraordinary item [para 21 of AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies].

In the given case, a limited company created 2.5% provision for doubtful debts for the year 2010-2011. Subsequently in 2011 the company revised the estimates based on the changed circumstances and wants to create 8% provision. As per AS-5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.

However, as per para 27 of AS 5 (Revised), a change in accounting estimate which has material effect in the current period, should be disclosed and quantified. Any change in the accounting estimate which is expected to have a material effect in later periods should also be disclosed and quantified.

Question 15

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

Decide whether a separate disclosure of arrear wages is required.

Answer

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

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Additional wages liability of ₹ 87 lakhs (from 1.4.2008 to 30.6.2012) should be included in current year's wages.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item.

However, as per para 12 of AS 5 (Revised), 'Net Profit or loss for the Period, Prior Period Items and Changes in the Accounting Policies', when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

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

Question 16

Goods of ₹ 5,00,000 were destroyed due to flood in September, 2009. A claim was lodged with insurance company, but no entry was passed in the books for insurance claim.

In March, 2012, the claim was passed and the company received a payment of ₹ 3,50,000 against the claim. Explain the treatment of such receipt in final accounts for the year ended 31st March, 2012.

Answer

As per the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", prior period items are income or expenses, which arise, in the current period as a result of error or omissions in the preparation of financial statements of one or more prior periods. Further, the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on current profit or loss can be perceived.

In the given instance, it is clearly a case of error in preparation of financial statements for the year 2009-10. Hence, claim received in the financial year 2011-12 is a prior period item and should be separately disclosed in the statement of Profit and Loss.

Question 17

S.T.B. Ltd. makes provision for expenses worth ₹ 7,00,000 for the year ending March 31, 2011, but the actual expenses during the year ending March 31, 2012 comes to ₹ 9,00,000 against provision made during the last year. State with reasons whether difference of ₹ 2,00,000 is to be treated as prior period item as per AS-5.

Answer

As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', as a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

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

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

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

Question 18

A company created a provision of ₹ 75,000 for staff welfare while preparing the financial statements for the year 2010 - 11. On 31st March, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welfare to ₹ 1,00,000. The accounts were approved by Board of Directors on 15th April, 2011

Explain the treatment of such revision in financial statements for the year ended 31st March, 2011

Answer

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the change in amount of staff welfare provision amounting ₹ 25,000 is neither a prior period item nor an extraordinary item. It is a change in estimate, which has been occurred in the year 2010 - 11.

As per the provisions of the standard, normally, all items of income and expense which are recognized in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates. However, the effect of such change in accounting estimate should be classified using the same classification in the statement of profit and loss, as was used previously, for the estimate.

Question 19

Give two examples on each of the following items:

- (i) *Change in Accounting Policy*
- (ii) *Change in Accounting Estimate*
- (iii) *Extra Ordinary Items*
- (iv) *Prior Period Items.*

Answer

(i) Examples of Changes in Accounting Policy:

- a. Change of depreciation method from WDV to SLM and vice-versa.
- b. Change in cost formula in measuring the cost of inventories.

(ii) Examples of Changes in Accounting Estimates:

- a. Change in estimate of provision for doubtful debts on sundry debtors.
- b. Change in estimate of useful life of fixed assets.

(iii) Examples of Extraordinary items:

- a. Loss due to earthquakes / fire / strike
- b. Attachment of property of the enterprise by government

(iv) Examples of Prior period items:

- a. Applying incorrect rate of depreciation in one or more prior periods.
- b. Omission to account for income or expenditure in one or more prior periods.

Question 20

Cost of a machine acquired on 01.04.2009 was ₹ 5,00,000. The machine is expected to realize ₹ 50,000 at the end of its working life of 10 years. Straight-line depreciation of ₹ 45,000 per year has been charged upto 2011-2012. For and from 2012-13, the company switched over to 15% p.a. reducing balance method of depreciation in respect of the machine. The new rate of depreciation is based on revised useful life of 15 years. The new rate shall apply with retrospective effect from 01.04.2009. State how would you deal with the above in the annual accounts of the Company for the year ended 31st March, 2013 in the light of AS 5.

Answer

WDV of asset at the end of year 2011-12= ₹ 5,00,000 – ₹ 45,000 x 3 = ₹ 3,65,000

WDV of asset at the end of year 2011-12 (by reducing balance method)

$$= ₹ 5,00,000 (1 - 0.15)^3 = ₹ 3,07,062.50$$

Depreciation to be charged in year 2012-13

$$= (\text{₹ } 3,65,000 - \text{₹ } 3,07,062.50) + 15\% \text{ of } \text{₹ } 3,07,062.50$$

$$\text{₹ } 57,937.50 + \text{₹ } 46,059.38 = \text{₹ } 1,03,997 \text{ (approx.)}$$

As per AS 5 'Net profit or loss for the period, Prior Period Items and Changes in Accounting Policies' the revision of remaining useful life is change in accounting estimate, and adoption of reducing balance method of depreciation instead of the straight-line method is change in accounting policy. Since it is difficult to segregate impact of these two changes, the entire amount of difference between depreciation at old rate and depreciation charged in 2012-13 (₹ 1,03,997 - ₹ 45,000 = ₹ 58,997) is regarded as an effect of change in accounting estimate as per provisions of the standard. The effect of this change in accounting estimate should be properly disclosed in the financial statements of the company for the year ended 31st March, 2013.

Question 21

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

Answer

The fall in estimated net realisable value of damaged stock ₹ 8,000 is the effect of change in accounting estimate. As per para 25 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the effect of a change in accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate. It is presumed that the loss by fire in the year ended 31.3.2012, i.e. difference of cost and NRV was shown in the profit and loss account as an extra-ordinary item. Therefore, in the year 2012-13, revision in accounting estimate should also be classified as extra-ordinary item in the profit and loss account and closing stock should be shown excluding the value of damaged stock.

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

| | ₹ |
|---|-----------------|
| Closing Stock (including damaged goods) | 1,50,000 |
| <i>Less:</i> Revised value of damaged goods | <u>(4,000)</u> |
| Closing stock (excluding damaged goods) | <u>1,46,000</u> |

AS 11 "THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES"

Question 22

Explain "monetary item" as per Accounting Standard 11. How are foreign currency monetary items to be recognized at each Balance Sheet date? Classify the following as monetary or non-monetary item:

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- (i) *Share Capital*
- (ii) *Trade Receivables*
- (iii) *Investments*
- (iv) *Fixed Assets.*

Answer

As per AS 11 'The Effects of Changes in Foreign Exchange Rates', Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Foreign currency monetary items should be reported using the closing rate at each balance sheet date. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realised from or required to disburse, such item at the balance sheet date.

| | |
|-------------------|--------------|
| Share capital | Non-monetary |
| Trade receivables | Monetary |
| Investments | Non-monetary |
| Fixed assets | Non-monetary |

Question 23

Beekay Ltd. purchased fixed assets costing ₹ 5,000 lakh on 01.04.2012 payable in foreign currency (US\$) on 05.04.2013. Exchange rate of 1 US\$ = ₹ 50.00 and ₹ 54.98 as on 01.04.2012 and 31.03.2013 respectively.

The company also obtained a soft loan of US\$ 1 lakh on 01.04.2012 payable in three annual equal instalments. First instalment was due on 01.05.2013.

You are required to state, how these transactions would be accounted for in the books of accounts ending 31st March, 2013.

Answer

As per AS 11 (Revised) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as an expense in the period in which they arise. However, Ministry of Corporate Affairs has recently amended AS 11 through a notification. As per the notification, exchange difference arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in

so far as they relate to requisition of depreciable capital asset, can be added to or deducted from cost of asset. The MCA has given an option for the enterprises to capitalize the exchange differences arising on reporting of long term foreign currency monetary items till 31st March, 2020. Thus the company can capitalize the exchange differences arising due to long term loans linked with the acquisition of fixed assets.

Transaction 1: Calculation of exchange difference on fixed assets

$$\text{Foreign Exchange Liability} = \frac{5,000}{50} = \text{US \$ } 100 \text{ lakhs}$$

$$\text{Exchange Difference} = \text{US \$ } 100 \text{ lakhs} \times (\text{₹ } 54.98 - \text{₹ } 50) = \text{₹ } 498 \text{ lakhs.}$$

Loss due to exchange difference amounting ₹ 498 lakhs will be capitalised and added in the carrying value of fixed assets. Depreciation on the unamortised amount will be provided in the remaining years

Transaction 2: Soft loan exchange difference (US \$ 1 lakh i.e ₹ 50 lakhs)

$$\text{Value of loan 31.3.13} \rightarrow \text{US \$ } 1 \text{ lakh} \times 54.98 = \text{₹ } 54,98,000$$

AS 11 also provides that in case of liability designated as long-term foreign currency monetary item (having a term of 12 months or more at the time of origination) the exchange difference is to be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) and should be written off over the useful life of such long-term liability, by recognition as income or expenses in each of such periods.

Exchange difference between reporting currency (INR) and foreign currency (USD) as on 31.03.2013 = US\$1.00 lakh X ₹ (54.98 – 50) = ₹ 4.98 lakh.

Loan account is to be increased to 54.98 lakh and FCMITD account is to be debited by 4.98 lakh. Since loan is repayable in 3 equal annual instalments, ₹ 4.98 lakh/3 = ₹ 1.66 lakh is to be charged in Profit and Loss Account for the year ended 31st March, 2013 and balance in FCMITD A/c ₹ (4.98 lakh – 1.66 lakh) = ₹ 3.32 lakh is to be shown on the 'Equity & Liabilities' side of the Balance Sheet as a negative figure under the head 'Reserve and Surplus' as a separate line item.

Note: The above answer is given on the basis that the company has availed the option under para 46A of AS 11

Question 24

(a) *Sterling Ltd. purchased a plant for US \$ 20,000 on 31st December, 2011 payable after 4 months. The company entered into a forward contract for 4 months @ ₹ 48.85 per dollar. On 31st December, 2011, the exchange rate was ₹ 47.50 per dollar.*

How will you recognize the profit or loss on forward contract in the books of Sterling Limited for the year ended 31st March, 2012.

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| (b) | Exchange Rate per \$ |
|---|----------------------|
| Goods purchased on 1.1.2011 of US \$ 10,000 | ₹ 45 |
| Exchange rate on 31.3.2011 | ₹ 44 |
| Date of actual payment 7.7.2011 | ₹ 43 |

Ascertain the loss/gain for financial years 2010-11 and 2011-12, also give their treatment as per AS 11.

Answer

(a) Calculation of profit or loss to be recognized in the books of Sterling Limited

| | ₹ |
|---|----------|
| Forward contract rate | 48.85 |
| Less: Spot rate | (47.50) |
| Loss | 1.35 |
| Forward Contract Amount | \$20,000 |
| Total loss on entering into forward contract = (\$20,000 × ₹ 1.35) | ₹ 27,000 |
| Contract period | 4 months |
| Loss for the period 1 st January, 2012 to 31 st March, 2012 i.e. 3 months falling in the year 2011-2012 will be $₹ 27,000 \times \frac{3}{4} =$ | ₹ 20,250 |

Balance loss of ₹ 6,750 (i.e. ₹ 27,000 – ₹ 20,250) for the month of April, 2012 will be recognized in the financial year 2012-2013.

(b) As per AS 11 on 'The Effects of Changes in Foreign Exchange Rates', all foreign currency transactions should be recorded by applying the exchange rate on the date of transactions. Thus, goods purchased on 1.1.2011 and corresponding creditor would be recorded at ₹ 4,50,000 (i.e. \$10,000 × ₹ 45)

According to the standard, at the balance sheet date all monetary transactions should be reported using the closing rate. Thus, creditor of US \$10,000 on 31.3.2011 will be reported at ₹ 4,40,000 (i.e. \$10,000 × ₹ 44) and exchange profit of ₹ 10,000 (i.e. 4,50,000 – 4,40,000) should be credited to Profit and Loss account in the year 2010-11.

On 7.7.2011, creditor of \$10,000 is paid at the rate of ₹ 43. As per AS 11, exchange difference on settlement of the account should also be transferred to Profit and Loss account. Therefore, ₹ 10,000 (i.e. 4,40,000 – 4,30,000) will be credited to Profit and Loss account in the year 2011-12.

Question 25

Sunshine Company Limited imported raw materials worth US Dollars 9,000 on 25th February, 2011, when the exchange rate was ₹ 44 per US Dollar. The transaction was recorded in the books at the above mentioned rate. The payment for the transaction was

made on 10th April, 2011, when the exchange rate was ₹ 48 per US Dollar. At the year end 31st March, 2011, the rate of exchange was ₹ 49 per US Dollar.

The Chief Accountant of the company passed an entry on 31st March, 2011 adjusting the cost of raw material consumed for the difference between ₹ 48 and ₹ 44 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11 (Revised).

Answer

As per para 9 of AS 11, 'The Effects of Changes in Foreign Exchange Rates', initial recognition of a foreign currency transaction is done in the reporting currency by applying the exchange rate at the date of the transaction. Accordingly, on 25th February 2011, the raw material purchased and its creditors will be recorded at US dollar 9,000 × ₹ 44 = ₹ 3,96,000.

Also, as per para 11 of the standard, on balance sheet date such transaction is reported at closing rate of exchange, hence it will be valued at the closing rate i.e. ₹ 49 per US dollar (USD 9,000 × ₹ 49 = ₹ 4,41,000) at 31st March, 2011, irrespective of the payment made for the same subsequently at lower rate in the next financial year.

The difference of ₹ 5 (49 – 44) per US dollar i.e. ₹ 45,000 (USD 9,000 × ₹ 5) will be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2011 and will not be adjusted against the cost of raw materials.

In the subsequent year on settlement date, the company would recognize or provide in the Profit and Loss account an exchange gain of ₹ 1 per US dollar, i.e. the difference from balance sheet date to the date of settlement between ₹ 49 and ₹ 48 per US dollar i.e. ₹ 9,000. Hence, the accounting treatment adopted by the Chief Accountant of the company is incorrect i.e. it is not in accordance with the provisions of AS 11.

Question 26

Mr. Y bought a forward contract for three months of US \$ 2,00,000 on 1st December 2010 at 1 US \$ = ₹ 44.10 when the exchange rate was 1 US \$ = ₹ 43.90. On 31-12-2010, when he closed his books, exchange rate was 1 US \$ = ₹ 44.20. On 31st January, 2011 he decided to sell the contract at ₹ 44.30 per Dollar. Show how the profits from the contract will be recognized in the books of Mr. Y.

Answer

As per para 39 of AS 11 'Changes in Foreign Exchange Rates', in recording a forward exchange contract intended for trading or speculation purpose, the premium or discount on the contract is ignored and at each balance sheet date, the value of contract is marked to its current market value and the gain or loss on the contract is recognised. Since the forward contract was for speculation purposes the premium on forward contract i.e. the difference between the spot rate and the forward contract rate will not be recorded in the books. Only when the forward contract is sold the difference between the forward contract rate and sale rate will be recorded in the Profit & Loss Account.

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| | ₹ |
|-------------------------------------|----------------|
| Sale rate | 44.30 |
| Less: Contract rate | <u>(44.10)</u> |
| Profit on sale of contract per US\$ | <u>00.20</u> |

| | |
|--------------------------------|----------------|
| Contract Amount | US \$ 2,00,000 |
| Total profit (2,00,000 x 0.20) | ₹ 40,000 |

Question 27

Stem Ltd. purchased a Plant for US\$ 30,000 on 30th November, 2013 payable after 6 months. The company entered into a forward contract for 6 months @ ₹ 62.15 per dollar. On 30th November, 2013, the exchange rate was ₹ 60.75 per dollar.

How will you recognise the profit or loss on forward contract in the books of Stem Ltd. for the year ended 31st March, 2014 ?

Answer

Calculation of Profit or Loss on forward contract to be recognised in the book of Stem Ltd.

| | |
|---|-------------------------------|
| <i>Forward contract rate</i> | <i>₹ 62.15 per dollar</i> |
| <i>Less: Spot Rate</i> | <i>₹ 60.75 per dollar</i> |
| <i>Loss</i> | <i>₹ 1.40 per dollar</i> |
| <i>Forward Contract Amount</i> | <i>US\$ 30000</i> |
| <i>Total Loss on entering into forward contract</i> | <i>= US\$ 30,000 x ₹ 1.40</i> |
| | <i>= ₹ 42,000</i> |

Contract Period *6 Months*

Out of total contract period of 6 months, 4 months are falling in the financial year 2013-14.

Loss for the period from 1st Dec.2013 to 31st March, 2014= (₹ 42,000/6) x 4 = ₹ 28,000.

Thus the loss amounting to ₹ 28,000 for the period is to be recognised in the year ended 31st March, 2014.

Question 28

Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3.2015.

Sundry Debtors include amount receivable from Umesh ₹ 5,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US \$ 1= ₹ 58.50.

Long term loan taken from a U.S. Company, amounting to ₹ 60,00,000. It was recorded at US \$ 1 = ₹ 55.60, taking exchange rate prevailing at the date of transaction.

US \$ 1 = ₹ 61.20 on 31.3.2015.

Answer

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

However, at the option of an entity, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a non-depreciable capital asset can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/ liability, by recognition as income or expense in each of such periods.

| Debtors | Foreign Currency Rate | ₹ |
|---|-----------------------|-----------|
| Initial recognition US \$ 8,547 (5,00,000/58.50) | 1 US \$ = ₹ 58.50 | 5,00,000 |
| Rate on Balance sheet date | 1 US \$ = ₹ 61.20 | |
| Exchange Difference Gain US \$ 8,547 X (61.20-58.50) | | 23,077 |
| Treatment: Credit Profit and Loss A/c by ₹ 23,077 | | |
| Long term Loan | | |
| Initial recognition US \$ 1,07,913.67 (60,00,000/55.60) | 1 US \$ = ₹ 55.60 | 60,00,000 |
| Rate on Balance sheet date | 1 US \$ = ₹ 61.20 | |
| Exchange Difference Loss US \$ 1,07,913.67 X (61.20 - 55.60) | | 6,04,317 |
| Treatment: Credit Loan A/c And Debit FCMITD A/C or Profit and Loss A/c by ₹ 6,04,317 | | |

Thus Exchange Difference on Long term loan amounting ₹ 6,04,317 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on debtors amounting ₹ 23,077 is required to be transferred to Profit and Loss A/c.

AS 12 "ACCOUNTING FOR GOVERNMENT GRANTS"

Question 29

Explain the treatment of refund of Government Grants as per Accounting Standard 12.

Answer

Para 11 of AS 12, "Accounting for Government Grants", explains treatment of government grants in following situations:

- (i) **When government grant is related to revenue**
 - (a) *When deferred credit account has a balance:* The amount of government grant refundable will be adjusted against unamortized deferred credit balance remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit the amount is immediately charged to profit and loss account.
 - (b) *Where no deferred credit account balance exists:* The amount of government grant refundable will be charged to profit and Loss account.
- (ii) **When government grant is related to specific fixed assets**
 - (a) *Where at the time of receipt, the amount of government grant reduced the cost of asset:* The amount of government grant refundable will increase the book value of the asset at the time of refund.
 - (b) *Where at the time of receipt, the amount of government grant was credited to "Deferred Grant Account":* The amount of government grant refundable will reduce the capital reserve or unamortized balance of deferred grant account as appropriate.
- (iii) **When government grant is in the nature of Promoter's contribution**

The amount of government grant refundable in part or in full on non-fulfillment of specific conditions, the relevant amount recoverable by the government will be reduced from capital reserve.

A government grant that becomes refundable is treated as an extra-ordinary item as per AS 5.

Question 30

Supriya Ltd. received a grant of ₹ 2,500 lakhs during the accounting year 2010-11 from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2011-12, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full. Elucidate the current accounting treatment, with reference to the provisions of AS-12.

Answer

As per para 11 of AS 12 'Accounting for Government Grants', Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

The amount refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

In the present case, the amount of refund of government grant should be shown in the profit & loss account of the company as an extraordinary item during the year 2011-12.

Question 31

A Ltd. purchased a machinery for ₹ 40 lakhs. (Useful life 4 years and residual value ₹ 8 lakhs) Government grant received is ₹ 16 lakhs.

Show the Journal Entry to be passed at the time of refund of grant in the third year and the value of the fixed assets, if:

- (1) *the grant is credited to Fixed Assets A/c.*
- (2) *the grant is credited to Deferred Grant A/c.*

Answer

In the books of A Ltd.

Journal Entries (at the time of refund of grant)

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

| | | ₹ | ₹ |
|---|--|----------|---------|
| I | Fixed Assets A/c Dr. To Bank A/c (Being grant refunded) The amount of refund should be ₹ 16 Lakhs | 16 lakhs | 16lakhs |

- II The balance of fixed assets after two years depreciation will be ₹ 16 lakhs (W.N.1) and after refund of grant it will become (₹ 16 lakhs + ₹ 16 lakhs) = ₹ 32 lakhs on which depreciation will be charged for remaining two years. Depreciation = $(32-8)/2 = ₹ 12$ lakhs p.a. will be charged for next two years.

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

As per para 14 of AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first

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two years ($\text{₹ } 16 \text{ lakhs} / 4 \text{ years}$) = $\text{₹ } 4 \text{ lakhs p.a.} \times 2 \text{ years} = \text{₹ } 8 \text{ lakhs}$ were credited to Profit and Loss Account and $\text{₹ } 8 \text{ lakhs}$ was the balance of Deferred Grant Account after two years.

Therefore, on refund in the 3rd year, following entry will be passed:

| | | | ₹ | ₹ |
|---|-----------------------------------|-----|---------|----------|
| I | Deferred Grant A/c | Dr. | 8 lakhs | 16 lakhs |
| | Profit & Loss A/c | Dr. | 8 lakhs | |
| | To Bank A/c | | | |
| | (Being Government grant refunded) | | | |

- II Deferred grant account will become Nil. The fixed assets will continue to be shown in the books at $\text{₹ } 24 \text{ lakhs}$ (W.N.2) and depreciation will continue to be charged at $\text{₹ } 8 \text{ lakhs}$ per annum for the remaining two years.

Working Notes:

- Balance of Fixed Assets after two years but before refund (under first alternative)

Fixed assets initially recorded in the books = $\text{₹ } 40 \text{ lakhs} - \text{₹ } 16 \text{ lakhs} = \text{₹ } 24 \text{ lakhs}$

Depreciation p.a. = $(\text{₹ } 24 \text{ lakhs} - \text{₹ } 8 \text{ lakhs}) / 4 \text{ years} = \text{₹ } 4 \text{ lakhs per year}$

Value of fixed assets after two years but before refund of grant

= $\text{₹ } 24 \text{ lakhs} - (\text{₹ } 4 \text{ lakhs} \times 2 \text{ years}) = \text{₹ } 16 \text{ lakhs}$

- Balance of Fixed Assets after two years but before refund (under second alternative)

Fixed assets initially recorded in the books = $\text{₹ } 40 \text{ lakhs}$

Depreciation p.a. = $(\text{₹ } 40 \text{ lakhs} - \text{₹ } 8 \text{ lakhs}) / 4 \text{ years} = \text{₹ } 8 \text{ lakhs per year}$

Book value of fixed assets after two years = $\text{₹ } 40 \text{ lakhs} - (\text{₹ } 8 \text{ lakhs} \times 2 \text{ years})$

= $\text{₹ } 24 \text{ lakhs}$

Note : It is assumed that the question requires the value of fixed assets is to be given after refund of government grant.

Question 32

Santosh Ltd. has received a grant of ₹ 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed ₹ 2 crores as dividend. Also, Santosh Ltd. received land free of cost from the State Government but it has not recorded it at all in the books as no money has been spent. In the light of AS 12 examine, whether the treatment of both the grants is correct.

Answer

As per AS 12 'Accounting for Government Grants', when government grant is received for a specific purpose, it should be utilized for the same. So the grant received for setting up a factory is not available for distribution of dividend.

In the second case, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value. The treatment of both the elements in the treatment of the grant is incorrect as per AS 12.

Question 33

Viva Ltd. received a specific grant of ₹ 30 lakhs for acquiring the plant of ₹ 150 lakhs during 2007-08 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet. During 2010-11, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the Government. Balance in the deferred income on that date was ₹ 21 lakhs and written down value of plant was ₹ 105 lakhs.

- (i) *What should be the treatment of the refund of the grant and the effect on cost of the fixed asset and the amount of depreciation to be charged during the year 2010-11 in profit and loss account?*
- (ii) *What should be the treatment of the refund, if grant was deducted from the cost of the plant during 2007-08 assuming plant account showed the balance of ₹ 84 lakhs as on 1.4.2010?*

Answer

As per para 21 of AS-12, 'Accounting for Government Grants', "the amount refundable in respect of a grant related to specific fixed asset should be recorded by reducing the deferred income balance. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

- (i) In this case the grant refunded is ₹ 30 lakhs and balance in deferred income is ₹ 21 lakhs, ₹ 9 lakhs shall be charged to the profit and loss account for the year 2010-11. There will be no effect on the cost of the fixed asset and depreciation charged will be on the same basis as charged in the earlier years.
- (ii) If the grant was deducted from the cost of the plant in the year 2007-08 then, para 21 of AS-12 states that the amount refundable in respect of grant which relates to specific fixed assets should be recorded by increasing the book value of the assets, by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Therefore, in this case, the book value of the plant shall be increased by ₹ 30 lakhs. The increased cost of ₹ 30 lakhs of the plant should be amortized over 7 years (residual life).

Depreciation charged during the year 2010-11 shall be $(84 + 30)/7$ years = ₹ 16.286 lakhs presuming the depreciation is charged on SLM.

Question 34

M/s A Ltd. has set up its business in a designated backward area with an investment of ₹ 200 Lakhs. The Company is eligible for 25% subsidy and has received ₹ 50 Lakhs from the Government.

Explain the treatment of the Capital Subsidy received from the Government in the Books of the Company.

Answer

As per para 10 of AS 12 "Accounting for Govt. Grants", Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve.

Subsidy received by A Ltd. is in the nature of promoter's contribution, since this grant is given with reference to the total investment in an undertaking and by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof. Therefore, this grant should be treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

AS16 "BORROWING COSTS"

Question 35

When capitalisation of borrowing cost should cease as per Accounting Standard 16?

Answer

Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

Question 36

GHI Limited obtained a loan for ₹ 70 lakhs on 15th April, 2010 from JKL Bank, to be utilized as under:

| | ₹ in lakhs |
|-------------------------------|------------|
| Construction of Factory shed | 25 |
| Purchase of Machinery | 20 |
| Working capital | 15 |
| Advance for purchase of Truck | 10 |

In March 2011, construction of the factory shed was completed and machinery, which was ready for its intended use, was installed. Delivery of Truck was received in the next financial year. Total interest of ₹ 9,10,000 was charged by the bank for the financial year ending 31-03-2011.

Show the treatment of interest under AS 16 and also explain the nature of Assets.

Answer

Treatment of Interest (Borrowing cost) as per AS 16 'Borrowing Costs'

| S. No. | Particulars | Nature | Interest to be capitalized | Interest to be charged to P & L A/c |
|--------|---|------------------------|--|--|
| | | | ₹ | ₹ |
| (i) | Construction of Factory Shed (Refer Note 1) | Qualifying Asset | $9,10,000 \times \frac{25}{70} = ₹ 3,25,000$ | |
| (ii) | Purchase of Machinery (Refer Note 2) | Not a Qualifying Asset | | $9,10,000 \times \frac{20}{70} = ₹ 2,60,000$ |
| (iii) | Working Capital | Not a Qualifying Asset | | $9,10,000 \times \frac{15}{70} = ₹ 1,95,000$ |
| (iv) | Advance for Purchase of Truck | Not a Qualifying Asset | | $9,10,000 \times \frac{10}{70} = ₹ 1,30,000$ |
| Total | | | ₹ 3,25,000 | ₹ 5,85,000 |

Notes:

- It is assumed that construction of a factory shed was completed on 31st March, 2011.

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2. It is assumed that the machinery being a non qualifying asset in this case, hence the interest cost would not be capitalized as it was ready for its intended use at the time of its acquisition
3. As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets* should be capitalized as part of the cost of that asset. Other borrowing costs are recognized as expense in the period in which they are incurred.
4. Since the advance for the purchase of truck was paid before March 2011 although the delivery was received in the next financial year, the money was used for its intended purpose and hence the interest will not be capitalized.

As per AS 16, assets have been defined as 'qualifying asset' and 'non-qualifying asset'.

- (i) **Qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale; whereas,
- (ii) **Non-qualifying asset** is an asset which is ready for its intended use or sale at the time of its acquisition.

Question 37

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

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

| | ₹ |
|-------------------------------------|------------------|
| <i>1st April, 2011</i> | <i>5,00,000</i> |
| <i>1st August, 2011</i> | <i>12,00,000</i> |
| <i>1st January, 2012</i> | <i>2,00,000</i> |

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

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

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

* A qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use or sale.

Answer

Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

| | ₹ |
|--|------------------|
| Cost of Plant (5,00,000 + 12,00,000 + 2,00,000) | 19,00,000 |
| <i>Add:</i> Amount of interest to be capitalised (W.N.2) | <u>1,54,000</u> |
| | <u>20,54,000</u> |

Journal Entry

| | | ₹ | ₹ |
|------------------------------|--|---------------|-----------|
| 31 st March, 2012 | Plant A/c To Bank A/c [Being amount of cost of plant and borrowing cost thereon capitalised] | Dr. 20,54,000 | 20,54,000 |

Working Notes:

1. Computation of average accumulated annual borrowing:

| | | ₹ |
|-------------------------------|---|------------------|
| 1 st April, 2011 | $\text{₹ } 5,00,000 \times \frac{12}{12}$ | 5,00,000 |
| 1 st August, 2011 | $\text{₹ } 12,00,000 \times \frac{8}{12}$ | 8,00,000 |
| 1 st January, 2012 | $\text{₹ } 2,00,000 \times \frac{3}{12}$ | <u>50,000</u> |
| | Annual Average Borrowing | <u>13,50,000</u> |

2. Amount of interest capitalized

| | ₹ |
|--|-----------------|
| On specific borrowing (₹ 4,00,000 × 10%) | 40,000 |
| On non-specific borrowings (₹ 13,50,000 – ₹ 4,00,000) = 9,50,000 × 12% | <u>1,14,000</u> |
| Amount of interest to be capitalized | <u>1,54,000</u> |

Question 38

On 1st April, 2011, Amazing Construction Ltd. obtained a loan of ₹ 32 crores to be utilized as under:

- (i) Construction of sealink across two cities:
(work was held up totally for a month during the year : ₹ 25 crores
due to high water levels)
- (ii) Purchase of equipments and machineries : ₹ 3 crores
- (iii) Working capital : ₹ 2 crores
- (iv) Purchase of vehicles : ₹ 50,00,000
- (v) Advance for tools/cranes etc. : ₹ 50,00,000
- (vi) Purchase of technical know-how : ₹ 1 crores
- (vii) Total interest charged by the bank for the year ending : ₹ 80,00,000
31st March, 2012

Show the treatment of interest by Amazing Construction Ltd.

Answer

According to para 3 of AS 16 'Borrowing costs', qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use.

As per para 6 of the standard, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The treatment of interest by Amazing Construction Ltd. can be shown as:

| | Qualifying Asset | Interest to be capitalized ₹ | Interest to be charged to Profit & Loss A/c ₹ | |
|--|------------------|---------------------------------|--|---------------------|
| Construction of sea-link | Yes | 62,50,000 | | [80,00,000*(25/32)] |
| Purchase of equipments and machineries | No | | 7,50,000 | [80,00,000*(3/32)] |
| Working capital | No | | 5,00,000 | [80,00,000*(2/32)] |
| Purchase of vehicles | No | | 1,25,000 | [80,00,000*(.5/32)] |
| Advance for tools, cranes etc. | No. | | 1,25,000 | [80,00,000*(.5/32)] |
| Purchase of technical know-how | No | | <u>2,50,000</u> | [80,00,000*(1/32)] |
| Total | | <u>62,50,000</u> | <u>17,50,000</u> | |

Question 39

Suhana Ltd. issued 12% secured debentures of ₹ 100 Lakhs on 01.05.2013, to be utilized as under:

| Particulars | Amount (₹ in lakhs) |
|----------------------------------|---------------------|
| Construction of factory building | 40 |
| Purchase of Machinery | 35 |
| Working Capital | 25 |

In March 2014, construction of the factory building was completed and machinery was installed and ready for its intended use. Total interest on debentures for the financial year ended 31.03.2014 was ₹ 11,00,000. During the year 2013-14, the company had invested idle fund out of money raised from debentures in banks' fixed deposit and had earned an interest of ₹ 2,00,000.

Show the treatment of interest under Accounting Standard 16 and also explain nature of assets.

Answer

According to para 6 of AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

Also para 10 of AS 16 "Borrowing Costs" states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost

$$= ₹ 11,00,000 - ₹ 2,00,000$$

$$= ₹ 9,00,000$$

| Sr. No. | Particulars | Nature of assets | Interest to be Capitalized (₹) | Interest to be charged to Profit & Loss Account (₹) |
|---------|----------------------------------|------------------------|---------------------------------|---|
| i | Construction of factory building | Qualifying Asset* | 9,00,000x40/100 = ₹ 3,60,000 | NIL |
| ii | Purchase of Machinery | Not a Qualifying Asset | NIL | 9,00,000x35/100 = ₹ 3,15,000 |

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| | | | | |
|-----|-----------------|------------------------|-------------------|---------------------------------|
| iii | Working Capital | Not a Qualifying Asset | NIL | 9,00,000x25/100 = ₹ 2,25,000 |
| | Total | | <u>₹ 3,60,000</u> | <u>₹ 5,40,000</u> |

* A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Question 40

A company capitalizes interest cost of holding investments and adds to cost of investment every year, thereby understating interest cost in profit and loss account. Comment on the accounting treatment done by the company in context of the relevant AS.

Answer

The Accounting Standard Board (ASB) has opined that investments other than investment in properties are not qualifying assets as per AS-16 Borrowing Costs. Therefore, interest cost of holding such investments cannot be capitalized. Further, even interest in respect of investment properties can only be capitalized if such properties meet the definition of qualifying asset, namely, that it necessarily takes a substantial period of time to get ready for its intended use or sale. Also, where the investment properties meet the definition of 'qualifying asset', for the capitalization of borrowing costs, the other requirements of the standard such as that borrowing costs should be directly attributable to the acquisition or construction of the investment property and suspension of capitalization as per paragraphs 17 and 18 of AS-16 have to be complied with.

Question 41

M/s. Ayush Ltd. began construction of a new building on 1st January, 2014. It obtained ₹ 3 lakh special loan to finance the construction of the building on 1st January, 2014 at an interest rate of 12% p.a. The company's other outstanding two non-specific loans were:

| Amount | Rate of Interest |
|-------------|------------------|
| ₹ 6,00,000 | 11% p.a. |
| ₹ 11,00,000 | 13% p.a. |

The expenditure that were made on the building project were as follows:

| | Amount (₹) |
|----------------|------------|
| January, 2014 | 3,00,000 |
| April, 2014 | 3,50,000 |
| July, 2014 | 5,50,000 |
| December, 2014 | 1,50,000 |

Building was completed on 31st December, 2014. Following the principles prescribed in AS 16 'Borrowing Cost', calculate the amount of interest to be capitalized and pass one Journal entry for capitalizing the cost and borrowing in respect of the building.

Answer

(i) Computation of average accumulated expenses

| | | ₹ |
|----------------------------|---|-----------------|
| ₹ 3,00,000 x 12 / 12 | = | 3,00,000 |
| ₹ 3,50,000 x 9 / 12 | = | 2,62,500 |
| ₹ 5,50,000 x 6 / 12 | = | 2,75,000 |
| ₹ <u>1,50,000</u> x 1 / 12 | = | <u>12,500</u> |
| <u>13,50,000</u> | | <u>8,50,000</u> |

(ii) Calculation of average interest rate other than for specific borrowings

| Amount of loan (₹) | Rate of interest | Amount of interest (₹) |
|---|------------------|------------------------|
| 6,00,000 | 11% = | 66,000 |
| <u>11,00,000</u> | 13% = | <u>1,43,000</u> |
| <u>17,00,000</u> | | <u>2,09,000</u> |
| Weighted average rate of interest $\left(\frac{2,09,000}{17,00,000} \times 100 \right)$ | = | 12.29*% |

(iii) Interest amount to be capitalized

| | | ₹ |
|--|---|-----------------|
| Specific borrowings (₹ 3,00,000 x 12%) | = | 36,000 |
| Non-specific borrowings [₹ 5,50,000 (₹ 8,50,000 – ₹ 3,00,000) x 12.29%] | = | <u>67,595</u> |
| Amount of interest to be capitalized | = | <u>1,03,595</u> |

* Rounded off

(iv) Journal Entry

| Date | Particulars | Dr. (₹) | Cr. (₹) |
|------------|---|-----------|-----------|
| 31.12.2014 | Building account (13,50,000+1,03,595) Dr. To Bank account (Being amount of cost of building and borrowing cost thereon capitalized) | 14,53,595 | 14,53,595 |

Question 42

Shan Builders Limited has borrowed a sum of US \$ 10,00,000 at the beginning of Financial Year 2014-15 for its residential project at LIBOR + 3 %. The interest is payable at the end of the Financial Year. At the time of availment, exchange rate was ₹ 56 per US \$ and the rate as on 31st March, 2015 ₹ 62 per US \$. If Shan Builders Limited borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2015 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

Answer

(i) Interest for the period 2014-15

$$= \text{US } \$ 10 \text{ lakhs} \times 4\% \times ₹ 62 \text{ per US } \$ = ₹ 24.80 \text{ lakhs}$$

(ii) Increase in the liability towards the principal amount

$$= \text{US } \$ 10 \text{ lakhs} \times ₹ (62 - 56) = ₹ 60 \text{ lakhs}$$

(iii) Interest that would have resulted if the loan was taken in Indian currency

$$= \text{US } \$ 10 \text{ lakhs} \times ₹ 56 \times 10.5\% = ₹ 58.80 \text{ lakhs}$$

(iv) Difference between interest on local currency borrowing and foreign currency borrowing
= ₹ 58.80 lakhs - ₹ 24.80 lakhs = ₹ 34 lakhs.

Therefore, out of ₹ 60 lakhs increase in the liability towards principal amount, only ₹ 34 lakhs will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 58.80 lakhs being the aggregate of interest of ₹ 24.80 lakhs on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 34 lakhs.

Hence, ₹ 58.80 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining ₹ 26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

AS 19 "LEASES"**Question 43**

Write short note on Sale and Lease Back Transactions as per Accounting Standard 19.

Answer

As per AS 19 on 'Leases', a sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the asset back to the vendor. The lease payments and the sale price are usually interdependent, as they are negotiated as a package. The accounting treatment of a sale and lease back transaction depends upon the type of lease involved.

If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sale proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

If sale and leaseback transaction results in a operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

Question 44

Explain the types of lease as per AS 19.

Answer

For the purpose of accounting AS 19 'Leases' classify the lease into two categories as follows:

- (i) Finance Lease
- (ii) Operating Lease

Finance Lease: It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership. As per para 8 of the standard, in following situations, the lease transactions are called Finance lease:

- The lessee will get the ownership of leased asset at the end of the lease term.
- The lessee has an option to buy the leased asset at the end of the lease term at price, which is lower than its expected fair value at the date on which option will be exercised.
- The lease term covers the major part of the life of asset even if title is not transferred.
- At the beginning of lease term, present value of minimum lease rental covers the initial fair value.

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- The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

Operating Lease: It is lease, which does not transfer all the risks and rewards incidental to ownership. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Question 45

Define the term Finance Lease. State any three situations when a lease would be classified as finance lease.

Answer

As per AS 19 'Leases', a finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

As per para 8 of the standard, classification of lease into a finance lease or an operating lease depends on the substance of the transaction rather than its form. Three situations which would normally lead to a lease being classified as a finance lease are:

- (a) the lessor transfers ownership of the asset to the lessee by the end of the lease term;
- (b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred.

Question 46

Annual lease rent = ₹ 40,000 at the end of each year

Lease period = 5 years

Guaranteed residual value = ₹ 14,000

Fair value at the inception (beginning) of lease = ₹ 1,50,000

Interest rate implicit on lease is 12.6%. The present value factors at 12.6% are 0.89, 0.79, 0.7, 0.622, 0.552 at the end of first, second, third, fourth and fifth year respectively.

Show the Journal entry to record the asset taken on finance lease in the books of the lessee.

Answer

Journal entry in the books of Lessee

| | | ₹ | ₹ |
|-----------|-----|----------|---|
| Asset A/c | Dr. | 1,49,888 | |

| | | |
|---|--|----------|
| To Lessor (Being recognition of finance lease as an asset and a liability) | | 1,49,888 |
|---|--|----------|

Working Note:

| Year | Lease Payments ₹ | Discounting Factor (12.6%) | Present Value ₹ |
|------|---------------------|-------------------------------|--------------------|
| 1 | 40,000 | 0.89 | 35,600 |
| 2 | 40,000 | 0.79 | 31,600 |
| 3 | 40,000 | 0.70 | 28,000 |
| 4 | 40,000 | 0.622 | 24,880 |
| 5 | 40,000 | 0.552 | 22,080 |
| 5 | 14,000 (GRV) | 0.552 | 7,728 |
| | | | 1,49,888 |

Question 47

B & P Ltd. availed a lease from N & L Ltd. The conditions of the lease terms are as under:

- (i) *Lease period is 3 years, in the beginning of the year 2010, for equipment costing ₹ 10,00,000 and has an expected useful life of 5 years.*
- (ii) *The Fair market value is also ₹ 10,00,000.*
- (iii) *The property reverts back to the lessor on termination of the lease.*
- (iv) *The unguaranteed residual value is estimated at ₹ 1,00,000 at the end of the year 2012*
- (v) *3 equal annual payments are made at the end of each year.*

Consider IRR = 10%.

The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is ₹ 0.7513.

The present value of annuity of ₹ 1 due at the end of 3rd year at 10% IRR is ₹ 2.4868.

State whether the lease constitute finance lease and also calculate unearned finance income.

Answer

- (i) **Computation of annual lease payment to the lessor**

| | ₹ |
|--|-----------|
| Cost of equipment | 10,00,000 |
| Unguaranteed residual value | 1,00,000 |
| Present value of residual value after third year @ 10% | |

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| | |
|--|-------------|
| (₹ 1,00,000 × 0.7513) | 75,130 |
| Fair value to be recovered from lease payments (₹ 10,00,000 – ₹ 75,130) | 9,24,870 |
| Present value of annuity for three years is 2.4868 | |
| Annual lease payment = ₹ 9,24,870/ 2.4868 | 3,71,911.70 |

The present value of lease payment i.e., ₹ 9,24,870 equals 92.48% of the fair market value i.e., ₹ 10,00,000. As the present value of minimum lease payments substantially covers the initial fair value of the leased asset and lease term (i.e. 3 years) covers the major part of the life of asset (i.e. 5 years). Therefore, it constitutes a finance lease.

(ii) Computation of Unearned Finance Income

| | ₹ |
|---|--------------------|
| Total lease payments (₹ 3,71,911.70 × 3) | 11,15,735 |
| Add: Unguaranteed residual value | <u>1,00,000</u> |
| Gross investment in the lease | 1,215,735 |
| Less: Present value of investment (lease payments and residual value) (₹ 75,130 + ₹ 9,24,870) | <u>(10,00,000)</u> |
| Unearned finance income | <u>2,15,735</u> |

Question 48

An equipment having expected useful life of 5 years, is leased for 3 years. Both the cost and the fair value of the equipment are ₹ 6,00,000. The amount will be paid in 3 equal installments and at the termination of lease, lessor will get back the equipment. The unguaranteed residual value at the end of 3rd year is ₹ 60,000. The IRR of the investment is 10%. The present value of annuity factor of ₹ 1 due at the end of 3rd year at 10% IRR is 2.4868. The present value of ₹ 1 due at the end of 3rd year at 10% rate of interest is 0.7513. State with reason whether the lease constitutes finance lease and also compute the unearned finance income.

Answer

(i) Determination of Nature of Lease

It is assumed that the fair value of the leased equipments is equal to the present value of minimum lease payments.

$$\begin{aligned} \text{Present value of residual value at the end of 3rd year} &= ₹ 60,000 \times 0.7513 \\ &= ₹ 45,078 \end{aligned}$$

$$\begin{aligned} \text{Present value of lease payments} &= ₹ 6,00,000 - ₹ 45,078 \\ &= ₹ 5,54,922 \end{aligned}$$

The percentage of present value of lease payments to fair value of the equipment is

$$(\text{₹ } 5,54,922 / \text{₹ } 6,00,000) \times 100 = 92.487\%.$$

Since, it substantially covers the major portion of the lease payments, the lease constitutes a finance lease.

(ii) Calculation of Unearned Finance Income

$$\text{Annual lease payment} = \text{₹ } 5,54,922 / 2.4868 = \text{₹ } 2,23,147 \text{ (approx)}$$

Gross investment in the lease = Total minimum lease payment + unguaranteed residual value

$$= (\text{₹ } 2,23,147 \times 3) + \text{₹ } 60,000 = \text{₹ } 6,69,441 + \text{₹ } 60,000 = \text{₹ } 7,29,441$$

Unearned finance income = Gross investment - Present value of minimum lease payments and unguaranteed residual value

$$= \text{₹ } 7,29,441 - \text{₹ } 6,00,000 = \text{₹ } 1,29,441$$

Question 49

Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being ₹ 7,00,000.

The economic life of machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays ₹ 3,00,000. The Lessee has guaranteed a residual value of ₹ 22,000 on expiry of the lease to the Lessor. However Lessor Ltd., estimates that the residual value of the machinery will be only ₹ 15,000. The implicit rate of return is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year.

Answer

As per para 11 of AS 19 "Leases", the lessee should recognize the lease as an asset and a liability at the inception of a finance lease. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Value of machinery

In the given case, fair value of the machinery is ₹ 7,00,000 and the net present value of minimum lease payments is ₹ 6,99,054*. As the present value of the machine is less than the fair value of the machine, the machine will be recorded at value of ₹ 6,99,054.

* Present value of minimum lease payments:

$$\begin{aligned} & \text{Annual lease rental} \times \text{PV factor} + \text{Present value of guaranteed residual value} \\ & = \text{₹ } 3,00,000 \times (0.869 + 0.756 + 0.657) + \text{₹ } 22,000 \times (0.657) \end{aligned}$$

Calculation of finance charges for each year

| <i>Year</i> | <i>Finance charge</i> | <i>Payment</i> | <i>Reduction in outstanding liability</i> | <i>Outstanding liability</i> |
|--------------------------------|-----------------------|----------------|---|------------------------------|
| | ₹ | ₹ | ₹ | ₹ |
| 1 st year beginning | - | - | - | 6,99,054 |
| End of 1 st year | 1,04,858 | 3,00,000 | 1,95,142 | 5,03,912 |
| End of 2 nd year | 75,587 | 3,00,000 | 2,24,413 | 2,79,499 |
| End of 3 rd year | 41,925 | 3,00,000 | 2,58,075 | 21,424** |

Question 50

X Ltd. sold JCB Machine having WDV of ₹ 50 Lakhs to Y Ltd for ₹ 60 Lakhs and the same JCB was leased back by Y Ltd to X Ltd. The lease is operating lease

Comment according to relevant Accounting Standard if

- (i) *Sale price of ₹ 60 Lakhs is equal to fair value*
- (ii) *Fair Value is ₹ 50 Lakhs and sale price is ₹45 Lakhs.*
- (iii) *Fair value is ₹ 55 Lakhs and sale price is ₹ 62 lakhs*
- (iv) *Fair value is ₹ 45 Lakhs and sale price is ₹ 48 Lakhs.*

Answer

According to AS 19, following will be the treatment in the given situations:

- (i) When sales price of ₹ 60 lakhs is equal to fair value, X Ltd. should immediately recognize the profit of ₹10 lakhs (i.e. 60 – 50) in its books.
- (ii) When fair value of leased JCB machine is ₹ 50 lakhs & sales price is ₹ 45 lakhs, then loss of ₹ 5 lakhs (50 – 45) to be immediately recognized by X Ltd. in its books provided loss is not compensated by future lease payments.
- (iii) When fair value is ₹ 55 lakhs & sales price is ₹ 62 lakhs, profit of ₹ 5 lakhs (55 - 50) to be immediately recognized by X Ltd. in its books and balance profit of ₹ 7 lakhs (62-55) is to be amortised/deferred over lease period.

$$= ₹ 6,84,600 + ₹ 14,454 = ₹ 6,99,054.$$

** The difference between this figure and guaranteed residual value (₹ 22,000) is due to approximation in computing the interest rate implicit in the lease.

- (iv) When fair value is ₹ 45 lakhs & sales price is ₹ 48 lakhs, then the loss of ₹ 5 lakhs (50-45) to be immediately recognized by X Ltd. in its books and profit of ₹ 3 lakhs (48-45) should be amortised/deferred over lease period.

Question 51

Classify the following into either operating or finance lease:

- (i) Lessee has option to purchase the asset at lower than fair value, at the end of lease term;
- (ii) Economic life of the asset is 7 years, lease term is 6 years, but asset is not acquired at the end of the lease term;
- (iii) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee;
- (iv) Present value (PV) of Minimum lease payment (MLP) = "X". Fair value of the asset is "Y".

Answer

- (i) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.
- (ii) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.
- (iii) Since the asset is procured only for the use of lessee, it is a finance lease.
- (iv) The lease is a finance lease if $X = Y$, or where X substantially equals Y.

Question 52

What do you understand by the term "Interest rate implicit on lease"?

Calculate the interest rate implicit on lease from the following details:

| | |
|---|---|
| <i>Annual Lease Rent</i> | <i>₹ 80,000 at the end of each year</i> |
| <i>Lease Period</i> | <i>5 Years</i> |
| <i>Guaranteed Residual Value</i> | <i>₹ 40,000</i> |
| <i>Unguaranteed Residual Value</i> | <i>₹ 24,000</i> |
| <i>Fair Value at the inception of the lease</i> | <i>₹ 3,20,000</i> |

Discounted rates for the first 5 years are as below:

At 10% 0.909, 0.826, 0.751, 0.683, 0.621

At 14% 0.877, 0.769, 0.675, 0.592, 0.519

Answer

As per para 3 of AS 19 'Leases' the interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

- (a) the minimum lease payments under a finance lease from the standpoint of the lessor; and
 (b) any unguaranteed residual value accruing to the lessor,
 to be equal to the fair value of the leased asset.

Present value at discount rate of 10%

| Year | Lease Payments (₹) | Disc. Factor (10%) | Present Value (₹) |
|------|--------------------|--------------------|-------------------|
| 1 | 80,000 | 0.909 | 72,720 |
| 2 | 80,000 | 0.826 | 66,080 |
| 3 | 80,000 | 0.751 | 60,080 |
| 4 | 80,000 | 0.683 | 54,640 |
| 5 | 80,000 | 0.621 | 49,680 |
| 5 | 40,000 | 0.621 | 24,840 |
| 5 | 24,000 | 0.621 | 14,904 |
| | Total | | <u>3,42,944</u> |

Present value at discount rate of 14%

| Year | Lease Payments (₹) | Disc. Factor (10%) | Present Value (₹) |
|------|--------------------|--------------------|-------------------|
| 1 | 80,000 | 0.877 | 70,160 |
| 2 | 80,000 | 0.769 | 61,520 |
| 3 | 80,000 | 0.675 | 54,000 |
| 4 | 80,000 | 0.592 | 47,360 |
| 5 | 80,000 | 0.519 | 41,520 |
| 5 | 40,000 | 0.519 | 20,760 |
| 5 | 24,000 | 0.519 | 12,456 |
| | Total | | <u>3,07,776</u> |

$$\text{Interest Rate Implicit on Lease} = 10\% + \frac{14\% - 10\%}{3,42,944 - 3,07,776} \times (3,42,944 - 3,20,000)$$

$$= 10\% + 2.609\% = 12.609\% \text{ or say } 12.61\%$$

Question 53

A machine having expected useful life of 6 years, is leased for 4 years. Both the cost and the fair value of the machinery are ₹ 7,00,000. The amount will be paid in 4 equal instalments and at the termination of lease, lessor will get back the machinery. The unguaranteed residual value at the end of the 4th year is ₹ 70,000. The IRR of the investment is 10%. The present

value of annuity factor of ₹ 1 due at the end of 4th year at 10% IRR is 3.169. The present value of ₹ 1 due at the end of 4th year at 10% rate of interest is 0.683.

State with reasons whether the lease constitutes finance lease and also compute the unearned finance income.

Answer

(i) *Determination of nature of lease*

Fair value of asset ₹ 7,00,000

Unguaranteed residual value ₹ 70,000

Present value of residual value at the end of 4th Year = ₹ 70,000 x 0.683 = ₹ 47,810

Present value of lease payment recoverable = ₹ 7,00,000 - ₹ 47,810

= ₹ 6,52,190

The percentage of present value of lease payment to fair value of the asset is

= (₹ 6,52,190/₹7,00,000)x100

= 93.17%

Since it substantially covers the major portion of lease payments and life of the asset, the lease constitutes a finance lease.

(ii) *Calculation of Unearned finance income*

Annual lease payment = ₹ 6,52,190 / 3.169

= ₹ 2,05,803 (approx.)

Gross investment in the lease = Total minimum lease payments + unguaranteed residual value.

= (₹ 2,05,803 x 4) + ₹70000

= ₹ 8,23,212 + ₹70,000 = ₹ 8,93,212

Unearned finance income = Gross investment – Present value of minimum lease payment and unguaranteed residual value.

= ₹ 8,93,212 – ₹ 7,00,000 (₹ 6,52,190 + ₹ 47,810)

= ₹ 1,93,212

Question 54

Aksat International Limited has given a machinery on lease for 36 months, and its useful life is 60 months. Cost & fair market value of the machinery is ₹ 5,00,000. The amount will be paid in 3 equal annual installments and the lessee will return the machinery to lessor at termination of lease. The unguaranteed residual value at the end of 3 years is ₹ 50,000. IRR of investment is 10% and present value of annuity factor of

₹ 1 due at the end of 3 years at 10% IRR is 2.4868 and present value of ₹ 1 due at the end of 3rd year at 10% IRR is 0.7513.

You are required to comment with reason whether the lease constitute finance lease or operating lease. If it is finance lease, calculate unearned finance income.

Answer

Determination of Nature of Lease

Present value of unguaranteed residual value at the end of 3rd year

$$= ₹ 50,000 \times 0.7513$$

$$= ₹ 37,565$$

Present value of lease payments

$$= ₹ 5,00,000 - ₹ 37,565$$

$$= ₹ 4,62,435$$

The percentage of present value of lease payments to fair value of the equipment is

$$(₹ 4,62,435 / ₹ 5,00,000) \times 100 = 92.487\%.$$

Since, lease payments substantially covers the major portion of the fair value; the lease constitutes a finance lease.

Calculation of Unearned Finance Income

Annual lease payment = ₹ 4,62,435 / 2.4868 = ₹ 1,85,956 (approx.)

Gross investment in the lease = Total minimum lease payments + unguaranteed residual value

$$= (₹ 1,85,956 \times 3) + ₹ 50,000$$

$$= ₹ 5,57,868 + ₹ 50,000 = ₹ 6,07,868$$

Unearned finance income

= Gross investment - Present value of minimum lease payments and unguaranteed residual value

$$= ₹ 6,07,868 - ₹ 5,00,000 = ₹ 1,07,868$$

AS 20 "EARNINGS PER SHARE"

Question 55

In the following list of shares issued, for the purpose of calculation of weighted average number of shares, from which date weight is to be considered:

- (i) Equity Shares issued in exchange of cash,*
- (ii) Equity Shares issued as a result of conversion of a debt instrument,*
- (iii) Equity Shares issued in exchange for the settlement of a liability of the enterprise,*

- (iv) Equity Shares issued for rendering of services to the enterprise,
 (v) Equity Shares issued in lieu of interest and/or principal of an other financial instrument,
 (vi) Equity Shares issued as consideration for the acquisition of an asset other than in cash.
 Also define Potential Equity Share.

Answer

The following dates should be considered for consideration of weights for the purpose of calculation of weighted average number of shares in the given situations:

- (i) Date of Cash receivable
 (ii) Date of conversion
 (iii) Date on which settlement becomes effective
 (iv) When the services are rendered
 (v) Date when interest ceases to accrue
 (vi) Date on which the acquisition is recognised.

A Potential Equity Share is a financial instrument or other contract that entitles, or may entitle its holder to equity shares.

Question 56

Net profit for the year 2012 : ₹ 24,00,000

Weighted average number of equity shares outstanding during the year 2012: 10,00,000

Average Fair value of one equity share during the year 2012 : ₹ 25.00

Weighted average number of shares under option during the year 2012: 2,00,000

Exercise price for shares under option during the year 2012 : ₹ 20.00

Compute Basic and diluted earnings per share.

Answer**Computation of earnings per share**

| | Earnings (₹) | Shares | Earnings per share |
|--|-----------------|-----------|-----------------------|
| Net profit for the year 2012 | 24,00,000 | | |
| Weighted average number of shares outstanding during the year 2012 | | 10,00,000 | |

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| | | | |
|--|-----------|------------|--------|
| <i>Basic earnings per share</i> | | | ₹ 2.40 |
| Number of shares under option | | 2,00,000 | |
| Number of shares that would have been issued at fair value: (2,00,000 x 20.00)/25.00 | -* | (1,60,000) | |
| <i>Diluted earnings per share</i> | 24,00,000 | 10,40,000 | ₹ 2.31 |

*The earnings have not been increased as the total number of shares has been increased only by the number of shares (40,000) deemed for the purpose of computation to have been issued for no consideration.

Question 57

In April, 2010, A Limited issued 18,00,000 Equity shares of ₹ 10 each, ₹ 5 per share was called up on that date which was paid by all the shareholders. The remaining ₹ 5 was called up on 1-9-2010. All the Shareholders (except one having 3,60,000 shares) paid the sum in September 2010. The net profit for the year ended 31-3-2011 is ₹ 33 lakhs after dividend on preference shares and dividend distribution tax of ₹ 6.60 lakhs.

Compute the basic EPS for the year ended 31st March, 2011 as per AS 20.

Answer

Basic Earnings per share (EPS) =

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

$$= \frac{33,00,000}{13,20,000 \text{ Shares (as per working note)}} = ₹ 2.5 \text{ per share}$$

Working Note:

Calculation of weighted average number of equity shares

As per para 19 of AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated as follows:

| <i>Date</i> | <i>No. of equity shares</i> | <i>Amount paid per share</i> | <i>Weighted average no. of equity shares</i> |
|-------------|-----------------------------|------------------------------|--|
| | ₹ | ₹ | ₹ |
| 1.4.2010 | 18,00,000 | 5 | 18,00,000 x 5/10 x 5/12 = 3,75,000 |
| 1.9.2010 | 14,40,000 | 10 | 14,40,000 x 7/12 = 8,40,000 |

| | | | |
|--------------|----------|---|---|
| 1.9.2010 | 3,60,000 | 5 | $3,60,000 \times 5/10 \times 7/12 = 1,05,000$ |
| Total shares | | | <u>13,20,000</u> |

Question 58

"While calculating diluted earning per share, effect is given to all dilutive potential equity shares that were outstanding during that period." Explain. Also calculate the diluted earnings per share from the following information:

| | | |
|---|---|-----------|
| Net profit for the current year | ₹ | 85,50,000 |
| No. of equity shares outstanding | | 20,00,000 |
| No. of 8% convertible debentures of ₹ 100 each | | 1,00,000 |
| Each debenture is convertible into 10 equity shares | | |
| Interest expenses for the current year | ₹ | 6,00,000 |
| Tax relating to interest expenses | | 30% |

Answer

"In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period." As per para 26 of AS 20 'Earnings per Share', the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding* during the period should be adjusted for the effects of all dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Computation of diluted earnings per share $\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$

Adjusted net profit for the current year

| | ₹ |
|--|-------------------|
| Net profit for the current year (assumed to be after tax) | 85,50,000 |
| Add: Interest expense for the current year | 6,00,000 |
| Less: Tax relating to interest expense (30% of ₹ 6,00,000) | <u>(1,80,000)</u> |
| Adjusted net profit for the current year | <u>89,70,000</u> |

Note: Conversion of convertible debentures into Equity Share is a dilutive potential equity shares. Hence, to compute the adjusted profit the interest paid on such debentures will be added back as the same would not be payable in case these are converted into equity shares.

* Weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

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Weighted average number of equity shares

Number of equity shares resulting from conversion of debentures

$$= \frac{1,00,000 \times 100}{10} = 10,00,000 \text{ Equity shares}$$

Weighted average number of equity shares used to compute diluted earnings per share

$$= [(20,00,000 \times 12) + (10,00,000 \times 9^{**})] / 12 = 27,50,000 \text{ shares}$$

$$\text{Diluted earnings per share} = \frac{89,70,000}{27,50,000 \text{ shares}} = ₹ 3.26 \text{ per share}$$

Question 59

Compute Basic Earnings per share from the following information:

| Date | Particulars | No. of shares |
|------------------------------|--------------------------------------|---------------|
| 1 st April, 2008 | Balance at the beginning of the year | 1,500 |
| 1 st August, 2008 | Issue of shares for cash | 600 |
| 31 st March, 2009 | Buy back of shares | 500 |

Net profit for the year ended 31st March, 2009 was ₹ 2,75,000.

Answer

Computation of weighted average number of shares outstanding during the period

| Date | No. of equity shares | Period outstanding | Weights (months) | Weighted average number of shares |
|------------------------------|------------------------|--------------------|------------------|-----------------------------------|
| (1) | (2) | (3) | (4) | (5) = (2) x (4) |
| 1 st April, 2008 | 1,500 (Opening) | 12 months | 12/12 | 1,500 |
| 1 st August, 2008 | 600 (Additional issue) | 8 months | 8/12 | 400 |
| 31 st March, 2009 | 500 (Buy back) | 0 months | 0/12 | - |
| Total | | | | 1,900 |

$$\text{Basic Earnings Per Share} = \frac{\text{Net Profit or Loss for the period attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares outstanding during the period}}$$

** Interest on debentures for full year amounts to ₹ 8,00,000 (i.e. 8% of ₹ 1,00,00,000). However, interest expense amounting ₹ 6,00,000 has been given in the question. It may be concluded that debentures have been issued during the year and interest has been provided for 9 months.

$$= \frac{2,75,000}{1,900 \text{ shares}} = ₹ 144.74$$

Question 60

Ram Ltd. had 12,00,000 equity shares on April 1, 2009. The company earned a profit of ₹ 30,00,000 during the year 2009-10. The average fair value per share during 2009-10 was ₹ 25. The company has given share option to its employees of 2,00,000 equity shares at option price of ₹ 15. Calculate basic E.P.S. and diluted E.P.S.

Answer**Computation of Earnings Per Share**

| | <i>Earnings</i> ₹ | <i>Shares</i> | <i>Earnings per share</i> ₹ |
|---|----------------------|------------------|--------------------------------|
| Net Profit for the year 2009-10 | 30,00,000 | | |
| Weighted average number of shares outstanding during the year 2009-10 | | 12,00,000 | |
| Basic Earning Per Share | | | 2.50 |
| = $\frac{30,00,000}{12,00,000}$ | | | |
| Number of shares under option | | 2,00,000 | |
| Number of shares that would have been issued at fair value (As indicated in Working Note) | | | |
| $[2,00,000 \times \frac{15}{25}]$ | | (1,20,000) | |
| Diluted Earnings Per Share | | | |
| $\left[\frac{30,00,000}{12,80,000} \right]$ | <u>30,00,000</u> | <u>12,80,000</u> | 2.34 |

Working Note:

The earnings have not been increased as the total number of shares has been increased only by the number of shares (80,000) deemed for the purpose of the computation to have been issued for no consideration

Question 61

From the following information relating to Y Ltd. Calculate Earnings Per Share (EPS):

| | ₹ in crores |
|--|-------------|
| Profit before V.R.S. payments but after depreciation | 75.00 |
| Depreciation | 10.00 |
| VRS payments | 32.10 |
| Provision for taxation | 10.00 |
| Fringe benefit tax | 5.00 |
| Paid up share capital (shares of ₹ 10 each fully paid) | 93.00 |

Answer

| | | ₹ in crores |
|--|-------------|----------------|
| Profit after depreciation but before VRS Payment | | 75.00 |
| Less: Depreciation – No. adjustment required | - | |
| VRS payments | 32.10 | |
| Provision for taxation | 10.00 | |
| Fringe benefit tax | <u>5.00</u> | <u>(47.10)</u> |
| Net Profit | | <u>27.90</u> |
| No. of shares | | 9.30 crores |

$$\text{EPS} = \frac{\text{Net profit}}{\text{No. of shares}} = \frac{27.90}{9.30} = ₹ 3 \text{ per share.}$$

Question 62

The following information is available for Raja Ltd. for the accounting year 2009-10 and 2010-11:

| Net profit for | ₹ |
|----------------|-----------|
| Year 2009-10 | 25,00,000 |
| Year 2010-11 | 40,00,000 |

No. of shares outstanding prior to right issue 12,00,000 shares.

- Right issue : One new share for each three outstanding i.e. 4,00,000 shares
 : Right issue price ₹ 22
 : Last date to exercise rights 30-6-2010

Fair value of one equity share immediately prior to exercise of rights on 30-6-2010 = ₹ 28.

You are required to compute the basic earnings per share for the years 2009-10 and 2010-11.

Answer

(a) Computation of basic earnings per share (EPS)

| | Year 2009-10 (₹) | Year 2010-11 (₹) |
|--|------------------------|------------------------|
| EPS for the year 2009-10 as originally reported = $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$ = $\frac{₹ 25,00,000}{12,00,000 \text{ shares}}$ | 2.08 | |
| EPS for the year 2009-10 restated for rights issue = $\frac{₹ 25,00,000}{(12,00,000 \text{ shares} \times 1.06)}$ * | 1.97 (approx.) | |
| EPS for the year 2010-11 including effects of right issue = $\frac{40,00,000}{\left(12,00,000 \times 1.06 \times \frac{3}{12}\right) + \left(16,00,000 \times \frac{9}{12}\right)}$ | | 2.64 (approx.) |

Working Notes:

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{total amount received from exercise}}{\text{Number of shares outstanding prior to exercise} + \text{number of shares issued in the exercise}}$$

1. Computation of theoretical ex-rights fair value per share

$$= \frac{(\₹ 28 \times 12,00,000 \text{ shares}) + (\₹ 22 \times 4,00,000 \text{ shares})}{12,00,000 \text{ shares} + 4,00,000 \text{ shares}} = ₹ 26.50$$

2. Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-right value per share}} = \frac{₹ 28}{₹ 26.5} = 1.06 \text{ (approx.)}$$

* The number of equity shares to be used in calculating basic earnings per share for periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the adjustment factor. The adjustment factor has been calculated in Working Note 2.

Question 63

XYZ Ltd. had issued 30,000, 15% convertible debentures of ₹ 100 each on 1st April, 2008.

The debentures are due for redemption on 1st March, 2011. The terms of issue of debentures provided that they were redeemable at a premium of 5% and also conferred option to the debenture holders to convert 20% of their holding into equity shares (Nominal Value ₹ 10) at a price of ₹ 15 per share. Debenture holders holding 2500 debentures did not exercise the option. Calculate the number of equity shares to be allotted to the Debenture holders exercising the option to the maximum.

Answer

Calculation of number of equity shares allotted to be debenture holders

| | No. of debenture |
|--|------------------|
| Total number of debentures | 30,000 |
| Less: Debenture holders not opted for conversion | <u>(2,500)</u> |
| | <u>27,500</u> |
| Option for conversion | 20% |
| | 5,500 |
| Number of debentures for conversion $(27,500 \times \frac{20}{100})$ | |
| Redemption value at a premium of 5% $(5,500 \times ₹ 105)$ | ₹ 5,77,500 |
| Number of equity shares to be allotted $\frac{₹ 5,77,500}{₹ 15}$ | 38,500 shares |

Question 64

- (i) Explain the concept of 'weighted average number of equity shares outstanding during the period'. State how would you compute, based on AS-20, the weighted average number of equity shares in the following case:

| | | No. of shares |
|--------------------------------|-------------------------------|---------------|
| 1 st April, 2010 | Balance of equity shares | 7,20,000 |
| 31 st August, 2010 | Equity shares issued for cash | 2,40,000 |
| 1 st February, 2011 | Equity shares bought back | 1,20,000 |
| 31 st March, 2011 | Balance of equity shares | 8,40,000 |

- (ii) Compute adjusted earnings per share and basic EPS based on the following information:

| | |
|--|-------------|
| Net profit 2009-10 | ₹ 7,20,000 |
| Net profit 2010-11 | ₹ 24,00,000 |
| No. of equity shares outstanding until 31 st December, 2010 | 8,00,000 |

Bonus issue on 1st January, 2011, 2 equity shares for each equity share outstanding at 31st December, 2010.

Answer

- (i) As per para 16 of AS 20, "Earnings Per Share", the weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or less number of shares outstanding at any time. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

Weighted average number of equity shares

| | |
|-----------------|--------------------------|
| 7,20,000 X 5/12 | = 3,00,000 shares |
| 9,60,000 X 5/12 | = 4,00,000 shares |
| 8,40,000 X 2/12 | <u>= 1,40,000 shares</u> |
| | <u>= 8,40,000 shares</u> |

- (ii) Earning per share

Basic EPS 2010-11 = ₹ 24,00,000/24,00,000 = ₹ 1

Adjusted EPS 2009-10 = ₹ 7,20,000/24,00,000 = ₹ 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2009-10, the earliest period reported.

Question 65

The following information is available for AB Ltd. for the accounting year 2012-13 and 2013-14:

| Net profit for | | ₹ |
|----------------|---------|-----------|
| Year | 2012-13 | 22,00,000 |
| Year | 2013-14 | 30,00,000 |

No of shares outstanding prior to right issue 10,00,000 shares.

Right issue: One new share for each five shares outstanding i.e. 2,00,000 shares.

: Right Issue price ₹ 25

: Last date to exercise right 31st July, 2013

Fair value of one equity share immediately prior to exercise of rights on 31.07.2013 is ₹ 32.

You are required to compute:

- (i) Basic earnings per share for the year 2012-13.
- (ii) Restated basic earnings per share for the year 2012-13 for right issue.
- (iii) Basic earnings per share for the year 2013-14.

Answer

Computation of Basic Earnings per Share

| | | Year 2012-13 (₹) | Year 2013-14 (₹) |
|-------|--|---------------------|---------------------|
| (i) | EPS for the year 2012-13 as originally reported = Net profit for the year attributable to equity share holder/weighted average number of equity shares outstanding during the year $\frac{₹ 22,00,000}{10,00,000 \text{ shares}}$ | 2.20 | |
| (ii) | EPS for the year 2012-13 restated for the right issue $\frac{₹ 22,00,000}{10,00,000 \text{ shares} \times 1.04}$ | 2.12 | |
| (iii) | EPS for the year 2013-14 (including effect of right issue) $\frac{₹ 30,00,000}{(10,00,000 \times 1.04 \times 4/12) + (12,00,000 \times 8/12)}$ | | 2.62 |

Working Notes:

1. Computation of theoretical ex-rights fair value per share =

$$\frac{(\text{₹ } 32 \times 10,00,000) + (\text{₹ } 25 \times 2,00,000)}{10,00,000 + 2,00,000} = \frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights} + \text{total amount received from exercise of rights}}{\text{Number of shares outstanding prior to exercise} + \text{number of shares issued in the exercise}}$$

$$= \text{₹ } 30.83$$

2. Computation of adjustment factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{₹ } 32}{\text{₹ } 30.83} = 1.04 \text{ (approx.)}$$

Question 66

What do you mean by "Weighted average number of equity shares outstanding during the period" and why is it required to be calculated? Compute weighted average number of equity shares in the following case:

| | | No. of shares |
|--------------------------------|--------------------------------|---------------|
| 1 st April, 2014 | Balance of Equity Shares | 5,00,000 |
| 30 th June, 2014 | Balance Shares issued for cash | 1,00,000 |
| 15 th January, 2015 | Equity Shares bought back | 50,000 |
| 31 st March, 2015 | Balance of Equity Shares | 5,50,000 |

Answer

As per AS 20, "Earnings Per Share", the weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time.

For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

Computation of weighted average number of shares outstanding during the period

| Date | No. of equity shares | Period outstanding | Weights (months) | Weighted average number of shares |
|------------------------------|-----------------------------------|--------------------|------------------|-----------------------------------|
| (1) | (2) | (3) | (4) | (5) = (2) x (4) |
| 1 st April, 2014 | 5,00,000 (Opening) | 3 months | 3 /12 | 1,25,000 |
| 30 th June 2014 | 6,00,000 (after Additional issue) | 6.5months | 6.5/12 | 3,25,000 |
| 15 th Jan, 2015 | 5,50,000 (after Buy back) | 2.5 months | 2.5/12 | 1,14,583 |
| 31 st March, 2015 | 5,50,000 (Balance) | 0 month | 0/12 | - |
| Total | | | | 5,64,583 |

AS 26 "INTANGIBLE ASSETS"

Question 67

Decide when research and development cost of a project can be deferred to future periods as per AS 26.

Answer

As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research should be recognized. The expenditure incurred on development phase can be deferred to the

subsequent years if the company can demonstrate all of the following conditions (as specified in para 44 of AS 26 'Intangible Assets'):

- (a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;
- (b) its intention to complete the intangible asset and use or sell it;
- (c) its ability to use or sell the intangible asset;
- (d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
- (f) its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Question 68

How is software acquired for internal use accounted for under AS-26?

Answer

Paragraphs 10 and 11 of Appendix A to the Accounting Standard 26 on Intangible Assets, lays down the following procedure for accounting of software acquired for internal use:-

- The cost of a software acquired for internal use should be recognised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of this statement.
- The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use.
- Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Statement which deal with the method of accounting for 'Separate Acquisitions', 'Acquisitions as a part of Amalgamations', Acquisitions by way of Government Grant', and 'Exchanges of Assets', need to be considered, as appropriate.

Recognition criteria as per paragraphs 20 and 21 of the standard are stated below:-

- An intangible asset should be recognised if, and only if:
 - (a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and
 - (b) the cost of the asset can be measured reliably.

- An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

Question 69

What are the costs that are to be included in Research and Development costs as per AS 26.

Answer

According to paras 41 and 43 of AS 26, "No intangible asset arising from research (or from the research phase of an internal project) should be recognized in the research phase. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.

Examples of research costs are:

- Costs of activities aimed at obtaining new knowledge;
- Costs of the search for, evaluation and final selection of, applications of research findings or other knowledge;
- Costs of the search for alternatives for materials, devices, products, processes, systems or services; and
- Costs of the activities involved in formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes systems or services."

According to paras 45 and 46 of AS 26, "In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

Examples of development activities/costs are:

- Costs of the design, construction and testing of pre-production or pre-use prototypes and models;
- Costs of the design of tools, jigs, moulds and dies involving new technology;
- Costs of the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- Costs of the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services."

Question 70

A Company had deferred research and development cost of ₹ 150 lakhs. Sales expected in the subsequent years are as under:

2.56 Advanced Accounting

| Years | Sales (₹ in lakhs) |
|-------|--------------------|
| I | 400 |
| II | 300 |
| III | 200 |
| IV | 100 |

You are asked to suggest how should Research and Development cost be charged to Profit and Loss account. If at the end of the III year, it is felt that no further benefit will accrue in the IV year, how the unamortised expenditure would be dealt with in the accounts of the Company?

Answer

- (i) Based on sales, research and development cost to be allocated as follows:

| Year | Research and Development cost allocation (₹ in lakhs) |
|------|--|
| I | $\frac{400}{1,000} \times 150 = 60$ |
| II | $\frac{300}{1,000} \times 150 = 45$ |
| III | $\frac{200}{1,000} \times 150 = 30$ |
| IV | $\frac{100}{1,000} \times 150 = 15$ |

- (ii) If at the end of the III year, the circumstances do not justify that further benefit will accrue in IV year, then the company has to charge the unamortised amount i.e. remaining ₹ 45 lakhs [150 – (60 + 45)] as an expense immediately.

Note: As per para 41 of AS 26 on Intangible Assets, expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. It has been assumed in the above solution that the entire cost of ₹ 150 lakhs is development cost. Therefore, the expenditure has been deferred to the subsequent years on the basis of presumption that the company can demonstrate all the conditions specified in para 44 of AS 26. An intangible asset should be derecognised when no future economic benefits are expected from its use according to para 87 of the standard. Hence the remaining unamortised amount of ₹ 45,00,000 has been written off as an expense at the end of third year.

Question 71

AB Ltd. launched a project for producing product X in October, 2009. The Company incurred ₹ 20 lakhs towards Research and Development expenses upto 31st March, 2011. Due to

prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years.

Advise the Company as per the applicable Accounting Standard.

Answer

As per para 41 of AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard. An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to para 87 of the standard. Therefore, the manager cannot defer the expenditure write off to future years.

Hence, the expenses amounting ₹ 20 lakhs incurred on the research and development project has to be written off in the current year ending 31st March, 2011.

Question 72

An enterprise acquired patent right for ₹ 400 lakhs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of estimated future cash flows which are as under:

| Year | Estimated Future Cash Flows (₹ in lakhs) |
|------|---|
| 1 | 200 |
| 2 | 200 |
| 3 | 200 |
| 4 | 100 |
| 5 | 100 |

After 3^d year, it was ascertained that the patent would have an estimated balance future life of 3 years and the estimated cash flow after 5th year is expected to be ₹ 50 lakhs. Determine the amortization under Accounting Standard 26.

Answer

Amortization of cost of patent as per AS 26

| Year | Estimated future cash flow (₹ in lakhs) | Amortization Ratio | Amortized Amount (₹ in lakhs) |
|------|--|--------------------|----------------------------------|
| 1 | 200 | .25 | 100 |
| 2 | 200 | .25 | 100 |
| 3 | 200 | .25 | 100 |

| | | | |
|---|-----|---------------|------------|
| 4 | 100 | .40 (Revised) | 40 |
| 5 | 100 | .40 (Revised) | 40 |
| 6 | 50 | .20 (Revised) | <u>20</u> |
| | | | <u>400</u> |

In the first three years, the patent cost will be amortised in the ratio of estimated future cash flows i.e. (200: 200: 200: 100: 100).

The unamortized amount of the patent after third year will be ₹ 100 (400-300) which will be amortised in the ratio of revised estimated future cash flows (100:100:50) in the fourth, fifth and sixth year.

Question 73

Plymouth Ltd. is engaged in research on a new process design for its product. It had incurred ₹ 10 lakh on research during first 5 months of the financial year 2012-13. The development of the process began on 1st September, 2012 and upto 31st March, 2013, a sum of ₹ 8 lakh was incurred as Development Phase Expenditure, which meets assets recognition criteria.

From 1st April, 2013, the Company has implemented the new process design and it is likely that this will result in after tax saving of ₹ 2 lakh per annum for next five years.

The cost of capital is 10%. The present value of annuity factor of ₹ 1 for 5 years @ 10% is 3.7908.

Decide the treatment of Research and Development Cost of the project as per AS 26.

Answer

Research Expenditure – According to AS 26 ‘Intangible Assets’, the expenditure on research of new process design for its product ₹ 10 lakhs should be charged to Profit and Loss Account in the year in which it is incurred. It is presumed that the entire expenditure is incurred in the financial year 2012-13. Hence, it should be written off as an expense in that year itself.

Cost of internally generated intangible asset – it is given that development phase expenditure amounting ₹ 8 lakhs incurred upto 31st March, 2013 meets asset recognition criteria. As per AS 26, for measurement of such internally generated intangible asset, fair value should be estimated by discounting estimated future net cash flows.

| | |
|--|----------------|
| Savings (after tax) from implementation of new design for next 5 years | ₹ 2 lakhs p.a. |
| Company's cost of capital | 10 % |
| Annuity factor @ 10% for 5 years | 3.7908 |
| Present value of net cash flows (₹ 2 lakhs x 3.7908) | ₹ 7.582 lakhs |

The cost of an internally generated intangible asset would be lower of cost value ₹ 8 lakhs or present value of future net cash flows ₹ 7.582 lakhs.

Hence, cost of an internally generated intangible asset will be ₹ 7.582 lakhs.

The difference of ₹ 0.418 lakhs (i.e. ₹ 8 lakhs – ₹ 7.582 lakhs) will be amortized by Plymouth for the financial year 2012-13.

Amortisation - The company can amortise ₹ 7.582 lakhs over a period of five years by charging ₹ 1.516 lakhs per annum from the financial year 2013-2014 onwards.

Question 74

NDA Corporation is engaged in research on a new process design for its product. It had incurred an expenditure of ₹ 530 lakhs on research upto 31st March, 2011

The development of the process began on 1st April, 2011 and Development phase expenditure was ₹ 360 lakhs upto 31st March, 2012 which meets assets recognition criteria.

From 1st April, 2012, the company will implement the new process design which will result in after tax saving of ₹ 80 lakhs per annum for the next five years.

The cost of capital of company is 10%.

Explain:

- (1) Accounting treatment for research expenses.
- (2) The cost of internally generated intangible asset as per AS 26.
- (3) The amount of amortization of the assets. (The present value of annuity factor of ₹ 1 for 5 years @ 10% = 3.7908)

Answer

- (1) **Research Expenditure** - According to para 41 of AS 26 'Intangible Assets', the expenditure on research of new process design for its product ₹ 530 lakhs should be charged to Profit and Loss Account in the year in which it is incurred. As the question states that the expenditure was incurred as ₹ 360 Lakhs in 2011-12 and ₹ 230 Lakhs in the financial year 2012-13 it should be written off as an expense in these two financial years
- (2) **Cost of internally generated intangible asset** - The question states that the development phase expenditure amounting ₹ 360 lakhs incurred upto 31st March, 2012 meets asset recognition criteria. As per AS 26 for measurement of such internally generated intangible asset, fair value can be estimated by discounting estimated future net cash flows.

| | |
|--|---------------|
| Savings (after tax) from implementation of new design for next 5 years | 80 lakhs p.a. |
| Company's cost of capital | 10 % |
| Annuity factor @ 10% for 5 years | 3.7908 |
| Present value of net cash flows (₹ 80 lakhs x 3.7908) | 303.26 lakhs |

The cost of an internally generated intangible asset would be lower of cost value ₹ 360 lakhs or present value of future net cash flows ₹303.26 lakhs.

Hence, cost of an internally generated intangible asset will be ₹ 303.26 lakhs.

The difference of ₹ 56.74 lakhs (i.e. ₹ 360 lakhs – ₹ 303.26 lakhs) will be amortized by the enterprise for the financial year 2011-12.

- (3) **Amortisation** - The company can amortise ₹ 303.26 lakhs over a period of five years by charging ₹ 60.65 lakhs per annum from the financial year 2012-13 onwards.

Question 75

M Ltd. launched a project for producing product A in Nov. 2008. The company incurred ₹ 30 lakhs towards Research and Development expenses upto 31st March, 2010. Due to unfavourable market conditions the management feels that it is not possible to manufacture and sell the product in the market for next so many years.

The management hence wants to defer the expenditure write off to future years.

Advise the company as per the applicable Accounting Standard.

Answer

As per para 41 of AS 26 "Intangible Assets", expenditure on research should be recognised as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard. An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to the provisions of AS 26. Therefore, the management cannot defer the expenditure write off to future years and the company is required to expense the entire amount of ₹ 30 lakhs in the Profit and Loss account of the year ended 31st March, 2010.

Question 76

A company acquired for its internal use a software on 28.01.2012 from the USA for US \$ 1,00,000. The exchange rate on that date was ₹ 52 per USD. The seller allowed trade discount @ 5 %. The other expenditure were:

- (i) Import Duty : 20%*
- (ii) Purchase Tax : 10%*
- (iii) Entry Tax : 5 % (Recoverable later from tax department)*
- (iv) Installation expenses : ₹ 25,000*
- (v) Profession fees for Clearance from Customs : ₹ 20,000*

Compute the cost of Software to be capitalized.

Answer

Calculation of cost of software (intangible asset) acquired for internal use

| | |
|---|-------------------|
| Purchase cost of the software | \$ 1,00,000 |
| Less: Trade discount @ 5% | <u>(\$ 5,000)</u> |
| | <u>\$ 95,000</u> |
| Cost in ₹ (US \$ 95,000 x ₹ 52) | 49,40,000 |
| Add: Import duty on cost @ 20% (₹) | <u>9,88,000</u> |
| | 59,28,000 |
| Purchase tax @ 10% (₹) | 5,92,800 |
| Installation expenses (₹) | 25,000 |
| Profession fee for clearance from customs (₹) | <u>20,000</u> |
| Cost of the software to be capitalized (₹) | <u>65,65,800</u> |

Note: Since entry tax has been mentioned as a recoverable / refundable tax, it is not included as part of the cost of the asset.

Question 77

Base Limited is showing an intangible asset at ₹ 85 lakhs as on 1-4-2011. This asset was acquired for ₹ 112 lakhs on 1-4-2008 and the same was available for use from that date. The company has been following the policy of amortization of the intangible asset over a period of 12 years on straight line basis. Comment on the accounting treatment of the above with reference to the relevant accounting standard.

Answer

As per para 63 of AS 26 "Intangible Assets," the depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimates of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortization should commence when the asset is available for use.

Base Limited has been following the policy of amortization of the intangible asset over a period of 12 years on straight line basis. The period of 12 years is more than the maximum period of 10 years specified as per AS 26.

Accordingly, Base Limited would be required to restate the carrying amount of intangible asset as on 1.4.2011 at ₹ 112 lakhs less ₹ 33.6 lakhs $\left(\frac{112 \text{ lakhs}}{10 \text{ years}} \times 3 \text{ years} \right) = ₹ 78.4 \text{ lakhs}$. The

difference of ₹ 6.6 lakhs i.e. (₹ 85 lakhs – ₹ 78.4 lakhs) will be adjusted against the opening balance of revenue reserve. The carrying amount of ₹ 78.4 lakhs would be amortized over remaining 7 years by ₹ 11.2 lakhs per year.

Question 78

2.62 Advanced Accounting

Hera Ltd. has got the license to manufacture particular medicines for 10 years at a license fee of ₹ 200 lakhs. Given below is the pattern of expected production and expected operating cash inflow:

| Year | Production in bottles (in thousands) | Net operating cash flow (₹ in lakhs) |
|------|--------------------------------------|--------------------------------------|
| 1 | 300 | 900 |
| 2 | 600 | 1,800 |
| 3 | 650 | 2,300 |
| 4 | 800 | 3,200 |
| 5 | 800 | 3,200 |
| 6 | 800 | 3,200 |
| 7 | 800 | 3,200 |
| 8 | 800 | 3,200 |
| 9 | 800 | 3,200 |
| 10 | 800 | 3,200 |

Net operating cash flow has increased for third year because of better inventory management and handling method. Suggest the amortization method.

Answer

As per para 72 of AS 26 'Intangibles Assets', the amortization method used should reflect the pattern in which economic benefits are consumed by the enterprise. If pattern cannot be determined reliably, then straight-line method should be used.

In the instant case, the pattern of economic benefit in the form of net operating cash flow vis-à-vis production is determined reliably. Initially net operating cash flow per thousand bottles is ₹ 3 lakhs for first two years and ₹ 4 lakhs from fourth year onwards, the pattern is established. Therefore Hera Ltd. should amortize the license fee of ₹ 200 lakhs as under:

| Year | Net Operating Cash Inflow (NOCI) | Ratio | Amortize amount (₹ in lakhs) |
|------|----------------------------------|-------|------------------------------|
| 1 | 900 | 0.03 | 6 |
| 2 | 1,800 | 0.06 | 12 |
| 3 | 2,300 | 0.08 | 16 |
| 4 | 3,200 | 0.12 | 24 |
| 5 | 3,200 | 0.12 | 24 |
| 6 | 3,200 | 0.12 | 24 |

| | | | |
|----|---------------|--------------------|------------|
| 7 | 3,200 | 0.12 | 24 |
| 8 | 3,200 | 0.12 | 24 |
| 9 | 3,200 | 0.12 | 24 |
| 10 | <u>3,200</u> | <u>0.11 (bal.)</u> | <u>22</u> |
| | <u>27,400</u> | <u>1.00</u> | <u>200</u> |

Question 79

A company is showing an intangible asset at ₹ 88 lakhs as on 01.04.2013. This asset was acquired for ₹ 120 lakhs on 01.04.2009 and the same was available for use from that date. The company has been following the policy of amortization of the intangible assets over a period of 15 years on straight line basis. Comment on the accounting treatment of the above with reference to the relevant Accounting Standard.

Answer

As per para 63 of AS 26 'Intangible Assets', the depreciable amount of an intangible asset should be allocated on systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use.

Company has been following the policy of amortisation of the intangible asset over a period of 15 years on straight line basis. The period of 15 years is more than the maximum period of 10 years specified as per AS 26.

Accordingly, the company would be required to restate the carrying amount of intangible asset as on 01.04.2013 at ₹ 72 lakhs i.e. ₹ 120 lakhs less ₹ 48 lakhs*.

The difference of ₹ 16 Lakhs (₹ 88 lakhs – ₹ 72 lakhs) will be adjusted against the opening balance of revenue reserve. The carrying amount of ₹ 72 lakhs will be amortised over remaining 6 years by amortising ₹ 12 lakhs per year.

Question 80

M/s. Mahesh Ltd. is developing a new production process. During the Financial Year ended 31st March, 2013, the total expenditure incurred on the process was ₹ 60 lacs. The production process met the criteria for recognition as an intangible asset on 1st December, 2012. Expenditure incurred till this date was ₹ 32 lacs.

Further expenditure incurred on the process for the Financial Year ending 31st March, 2014 was ₹ 90 lacs. As on 31-03-2014, the recoverable amount of know-how embodied in the

$$* \left(\frac{\text{₹ 120 Lakhs}}{10 \text{ years}} \times 4 \text{ years} = 48 \text{ Lakhs} \right)$$

process is estimated to be ₹ 82 lacs. This includes estimates of future cash outflows and inflows:

You are required to work out:

- (i) What is the expenditure to be charged to Profit & Loss Account for the year ended 31st March, 2013 ?
- (ii) What is the carrying amount of the intangible asset as on 31st March, 2013 ?
- (iii) What is the expenditure to be charged to Profit & Loss Account for the year ended 31st March, 2014 ?
- (iv) What is the carrying amount of the intangible asset as on 31st March, 2014 ?

Answer

As per AS 26 'Intangible Assets'

- (i) Expenditure to be charged to Profit and Loss account for the year ending 31.03.2013

₹ 32 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2012. This expenditure will not form part of the cost of the production process recognized as an intangible asset in the balance sheet.

- (ii) Carrying value of intangible asset as on 31.03.2013

At the end of financial year, on 31st March 2013, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 28 (60-32) lacs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st December 2012).

- (iii) Expenditure to be charged to Profit and Loss account for the year ended 31.03.2014

| | (₹ in lacs) |
|----------------------------------|-------------|
| Carrying Amount as on 31.03.2013 | 28 |
| Expenditure during 2013 – 2014 | <u>90</u> |
| Book Value | 118 |
| Recoverable Amount | <u>(82)</u> |
| Impairment loss | <u>36</u> |

₹ 36 lakhs to be charged to Profit and loss account for the year ending 31.03.2014.

- (iv) Carrying value of intangible asset as on 31.03.2014

| | (₹ in lacs) |
|------------|-------------|
| Book Value | 118 |

| | |
|----------------------------------|-----------|
| Less: Impairment loss | (36) |
| Carrying amount as on 31.03.2014 | <u>82</u> |

AS 29 'PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS'**Question 81**

X Ltd. has its financial year ended 31.3.2011, fifteen law suits outstanding, none of which has been settled by the time the accounts are approved by the directors. The directors have estimated that the probable outcomes as below:

| <i>Result</i> | <i>Probability</i> | <i>Amount of Loss</i> ₹ |
|----------------------------------|--------------------|----------------------------|
| <i>For first ten cases:</i> | | |
| <i>Win</i> | <i>0.6</i> | ---- |
| <i>Loss-low damages</i> | <i>0.3</i> | <i>90,000</i> |
| <i>Loss-high damages</i> | <i>0.1</i> | <i>2,00,000</i> |
| <i>For remaining five cases:</i> | | |
| <i>Win</i> | <i>0.5</i> | ---- |
| <i>Loss-low damages</i> | <i>0.3</i> | <i>60,000</i> |
| <i>Loss-high damages</i> | <i>0.2</i> | <i>1,00,000</i> |

The directors believe that the outcome of each case is independent of the outcome of all the others.

Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.

Answer

According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

- (i) There is a present obligation arising out of past events but not recognized as provision.
- (ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- (iii) The possibility of an outflow of resources embodying economic benefits is also remote.
- (iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning first 10 cases is 60% and for remaining five cases is 50%. In other words, probability of losing the cases is 40% and 50% respectively. According to AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the probability or possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore, disclosure by way of note of contingent liability amount may be calculated as under:

| | |
|---------------------------------------|--|
| Expected loss in first ten cases | = [₹ 90,000 x 0.3 + ₹ 2,00,000 x 0.1] x 10 |
| | = [₹ 27,000 + ₹ 20,000] x 10 |
| | = ₹ 47,000 x 10 = ₹ 4,70,000 |
| Expected loss in remaining five cases | = [₹ 60,000 x 0.3 + ₹ 1,00,000 x 0.2] x 5 |
| | = [₹ 18,000 + ₹ 20,000] x 5 |
| | = ₹ 38,000 x 5 = ₹ 1,90,000 |
| Total contingent liability | = ₹ 4,70,000 + ₹ 1,90,000 = ₹ 6,60,000. |

Question 82

Shyam Ltd. (a Public Sector Company) provides consultancy and engineering services to its clients. In the year 2010-11, the Government has set up a commission to decide about the pay revision. The pay will be revised with respect from 1-1-2006 based on the recommendations of the commission. The company makes the provision of ₹ 680 lakhs for pay revision in the financial year 2010-11 on the estimated basis as the report of the commission is yet to come. As per the contracts with the client on cost plus job, the billing is done on the actual payment made to the employees and allocated to jobs based on hours booked by these employees on each job.

The company discloses through notes to accounts:

"Salaries and benefits include the provision of ₹ 680 lakhs in respect of pay revision. The amount chargeable from reimbursable jobs will be billed as per the contract when the actual payment is made".

The accountant feels that the company should also book/recognise the income by ₹ 680 lakhs in Profit and Loss Account as per the terms of the contract. Otherwise, it will be the violation of matching concept & understatement of profit. Comment on the opinion of the Accountant with reference to relevant accounting standards.

Answer

As per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that

reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provisions.

Accordingly, potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. In this case, the provision of salary to employees of ₹ 680 lakhs will be ultimately collected from the client, as per the terms of the contract. Therefore, the liability of ₹ 680 lakhs is matched by the counter claim from the client. Hence, the provision for salary of employees should be matched with the reimbursable asset to be claimed from the client. It appears that the whole amount of Rs. 680 lakhs is recoverable from client and there is no significant uncertainty about the collection. Hence, the net charge to profit and loss account should be nil.

The opinion of the accountant regarding recognition of income of ₹ 680 lakhs is not as per AS-29 and also the concept of prudence will not be followed if ₹ 680 lakhs is simultaneously recognized as income. ₹ 680 lakhs is not the revenue at present but only reimbursement of claim for which an asset is created. However the accountant is correct to the extent as that non- recognition of ₹ 680 lakhs as income will result in the understatement of profit. To avoid this, in the statement of profit and loss, expense relating to provision may be presented net of the amount recognized for reimbursement.

Question 83

An airline is required by law to overhaul its aircraft once in every five years. The Pacific Airlines which operate aircrafts does not provide any provision as required by law in its final accounts. Discuss with reference to relevant Accounting Standard 29.

Answer

A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29.

The cost of overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts. Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts. Further, the enterprise can avoid the future expenditure by its future action, for example by selling the aircraft. However, an obligation might arise to pay fines or penalties under the legislation after completion of five years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than five years.

Question 84

An engineering goods company provides after sales warranty for 2 years to its customers. Based on past experience, the company has been following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period:

Less than 1 year : 2% provision

More than 1 year : 3% provision

The company has raised invoices as under:

| Invoice Date | Amount (₹) |
|--------------------|------------|
| 19th January, 2011 | 40,000 |
| 29th January, 2012 | 25,000 |
| 15th October, 2012 | 90,000 |

Calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2012 and 31st March, 2013. Also compute amount to be debited to Profit and Loss Account for the year ended 31st March, 2013.

Answer

Provision to be made for warranty under AS 29 'Provisions, Contingent Liabilities and Contingent Assets'

$$\begin{aligned} \text{As at 31st March, 2012} &= ₹ 40,000 \times .02 + ₹ 25,000 \times .03 \\ &= ₹ 800 + ₹ 750 = ₹ 1,550 \end{aligned}$$

$$\begin{aligned} \text{As at 31st March, 2013} &= ₹ 25,000 \times .02 + ₹ 90,000 \times .03 \\ &= ₹ 500 + ₹ 2,700 = ₹ 3,200 \end{aligned}$$

Amount debited to Profit and Loss Account for year ended 31st March, 2013

| | ₹ |
|--|----------------|
| Balance of provision required as on 31.03.2013 | 3,200 |
| Less: Opening Balance as on 1.4.2012 | <u>(1,550)</u> |
| Amount debited to profit and loss account | <u>1,650</u> |

Note: No provision will be made on 31st March, 2013 in respect of sales amounting ₹ 40,000 made on 19th January, 2011 as the warranty period of 2 years has already expired.

Question 85

WZW Ltd. is in dispute involving allegation of infringement of patents by a competitor company who is seeking damages of a huge sum of ₹ 1000 Lakhs. The directors are of the opinion that

the claim can be successfully resisted by the company. How would you deal the same in the Annual Accounts of the company?

Answer

As per para 14 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a provision should be recognised when:

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

If these conditions are not met, no provision should be recognised.

A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. The possibility of an outflow of resources embodying economic benefits seems to be remote in the given situation, since the directors of WZW Ltd. are of the opinion that the claim can be successfully resisted by the company. Therefore, the company shall not disclose the same as contingent liability. However, following note in this regard may be given in annual accounts of the company:

"Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of ₹ 1,000 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company".

Exercise

1. *The difference between actual expense or income and the estimated expense or income as accounted for in earlier years' accounts, does not necessarily constitute the item to be a prior period item comment.*

(Hints: The statement given in the question is correct)

2. *(i) A major fire has damaged the assets in a factory of a limited company on 2nd April-two days after the year end closure of account. The loss is estimated at ₹ 20 crores out of which ₹ 12 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.*
- (ii) There is a sales tax demand of ₹ 2.50 crores against a company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The grounds of appeal deal with points covering ₹ 2 crores of the demand. State how the matter will have to be dealt with in the final accounts for the year.*

(Hints: (i) The loss due to break out of fire is an example of event occurring after the balance sheet date that does not relate to conditions existing at the balance sheet date. (ii)

2.70 Advanced Accounting

Company should disclose the disputed part of sales tax liability of ₹ 2 crore as contingent liability in their financial statements of the year.)

3. Rohini Limited has obtained loan from an Institution for ₹ 500 lacs for modernization and renovation of its plant and machinery. The installation of plant and machinery was completed on 31.3.2012 amounting to ₹ 320 lacs and ₹ 50 lacs were advanced to suppliers of additional assets and the balance of ₹ 130 lacs has been utilized for working capital requirements. Total interest paid for the above loan amounted to ₹ 65 lacs during 2011-12. You are required to state how the interest on institutional loan is to be accounted for in the year 2011-12.

(Hint):

| | |
|--|---|
| Interest to be capitalised (₹ in lakhs) 48.10 | Interest to be charged to Profit and Loss A/c (₹ in lakhs) 16.90 |
|--|---|