2

Accounting Standards

Learning objectives

After studying this chapter, you will be able to:

- Understand the provisions of the Accounting Standards specified in the syllabus.
- Solve the practical problems based on application of Accounting Standards.

1. Introduction

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks. You must have already studied the concept, objectives, benefits and limitations, applicability and compliance of Accounting Standards, in detail, in Chapter 1 of "Accounting" Intermediate (IPC) Course Study Material – Group I. We shall discuss the Accounting Standards (specified in the syllabus) in this chapter taking individual standard in detail.

2. Overview

2.1 AS 4: Contingencies and Events Occurring After the Balance Sheet Date

Accounting Standard 4 'Contingencies and Events Occurring after the Balance Sheet Date' covers accounting treatment of

(i) contingencies and

(ii) events occurring after the balance sheet date.

Thus all paragraphs of AS 4 (Revised) that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For

example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard. Thus, the present standard (AS 4 (Revised)) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet.

Definitions

The following terms are used in this Statement with the meanings specified:

- **A *contingency*** is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.
- ***Events occurring after the balance sheet date*** are those significant events, both favourable 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, and, by the corresponding approving authority in the case of any other entity.

  Two types of events can be identified:

  (a) those which provide further evidence of conditions that existed at the balance sheet date; and

  (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Events Occurring after Balance Sheet Date

Transactions are financial events. It is obvious that all financial events upto the balance sheet date should be taken into consideration in preparation of financial statements for an accounting period. Certain significant events may however occur after the balance sheet date, the knowledge of which is important for making assessment of performance and affairs of the reporting enterprise during the accounting period and also for making projections for the future. It is clearly important to communicate such events to the users of financial statements as far as possible. It is impractical to require enterprises to report events after approval of financial statements because such a requirement necessitates fresh approval of financial statements and thus starts an endless cycle of change of report and fresh approval.

Paragraph 3 of the standard define that events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in case of companies and by the corresponding approving authority in case of other entities.

The events occurring after the balance sheets can be reported either by

(i) making appropriate adjustments in the financial statements or

(ii) through report of the approving authority, i.e. Directors' Report in case of companies and report of corresponding approving authority in case of other entities.

Adjusting Events

- An event after the balance sheet may require adjustment of reported values of assets, liability, expenses, income and equity for the accounting period, if the event is such as to provide further evidence of conditions that existed at the balance sheet date. Such events are adjusting events.
- For example, if a fraud during the accounting period is detected after the balance sheet date but before approval of the financial statement, it is necessary to recognise the loss and change the reported values concerned elements of financial statement. (Paragraph 13)

Disclosure

- The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.
- If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote. If a reliable estimate of the financial effect cannot be made, this fact is disclosed.
- When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Example 1

A Ltd., whose accounting year ends on 31/03/2013, agreed in principle to sell a plot of land on 18/03/2013 at a price to be determined by an independent valuer. Pending the agreement for sale and due to non-receipt of valuers report, the sale of the land could not be completed up to 31/03/13. The company received the report on April 7, 2013 and the agreement was signed on April 10, 2013. The financial statements for 2012-13 were approved by the board on May 12, 2013.

The sale of land is an event occurring after the balance sheet date. Also, the condition, which led to the sell, existed on the balance sheet date. The signing of the agreement provides further evidence as to the condition that existed on the balance sheet date. The sale of land after the balance sheet date is therefore an adjusting event, which means the sale transaction should be recorded in books of A Ltd. for the purpose of its financial statements for 2012-13.

Non-adjusting events

- Events after balance sheet date may result from conditions arising subsequent to the balance sheet date. Such events do not justify change in the reported values of assets,

liabilities, expenses, income or equity.

- Such events, if they represent material changes and commitments affecting financial position of the enterprise, should be disclosed in the report of approving authority, i.e. Directors' Report in case of companies and report of corresponding approving authority in case of other entities.
- For example, an announcement after balance sheet date but before approval of financial statement, of a formal plan to discontinue an operation does not justify adjustment of financial statement of the accounting period already over, but is indicative of material change in future. Such events should be disclosed in the report of approving authority* (Paragraph 15).
- As per paragraph 17 of the standard, in reporting non-adjusting events, the directors (or other approving authority, as the case may be) should state the nature of the event along with their estimate of financial effect of the event. Where estimate of financial effect cannot be made, the report should state the fact that such an estimate cannot be made.

Dividends

There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes. If an enterprise declares dividends to shareholders after the balance sheet date, the enterprise should not recognise those dividends as a liability at the balance sheet date unless a statute requires otherwise. Such dividends should be disclosed in notes.

No liability for proposed dividends has to be created now. Such proposed dividends are to be disclosed in the notes to the financial statements. Thus, no liability for proposed dividends needs to be recognised for financial statements for year ended 2016-17 and subsequent years. Such proposed dividends are to be disclosed in the notes as per Companies (Accounting Standards) Amendment Rules, 2016issued on 30 March 2016.

Example 2

An earthquake destroyed a major warehouse of C Ltd. on April 20, 2013. The last accounting year of the company ended on 31/03/13 and the financial statements for the year were approved on May 8, 2013. The destruction of warehouse is a significant event occurring after the balance

sheet date, but since the earthquake did not exist on the balance sheet date, the destruction by earthquake is a non-adjusting event. The value of property lost by earthquake therefore need not be recognised in financial statement of 2012-13.

The Report of the Directors for 2012-13 should disclose the fact of earthquake together with an estimate of loss on earthquake. If no estimate of loss can be made, the report should state that loss on earthquake could not be estimated.

Example 3

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

Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on 31st March. Thus the collection of cheques after balance sheet date is not an adjusting event. Recognition of cheques in hand is therefore not consistent with requirements of AS 4. Moreover, the collection of cheques after balance sheet date does not represent any material change or commitments affecting financial position of the enterprise, and so no disclosure of such collections in the Directors' Report is necessary.

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

Exception to rule:

Events indicating going concern assumption inappropriate: As per paragraph 13 of the standard, an event occurring after the balance sheet date shall be an adjusting event even if it does not reflect any condition existing on the balance sheet date, if the event is such as to indicate that the fundamental accounting assumption of going concern is no longer appropriate.

Suppose a fire occurred in the factory and office premises of an enterprise after 31/03/13 but before approval of financial statement of 2012-13. The loss on fire is of such a magnitude that it is not reasonable to expect the enterprise to start operations again. Since the fire occurred after 31/03/13, the loss on fire is not a result of any condition existing on 31/03/13. Yet, the loss should be recognised in the statement of profit and loss for 2012-13 and the assets lost should be written off from the balance sheet dated 31/03/13.

Illustration 1

In X Co. Ltd., theft of cash of ₹ 5 lakhs by the cashier in January, 2013 was detected only in May, 2013. 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 31.3.2013. Decide.

Solution

As per paragraph 13 of AS 4 (revised) 'Contingencies and Events occurring after the Balance Sheet Date', an event occurring after the balance sheet date may require adjustment to the reported values of assets, liabilities, expenses or incomes.

If a fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognize the loss amounting ₹ 5,00,000 and adjust the accounts of the company for the year ended 31st March, 2013.

Illustration 2

An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.2012. The accounting year of the company ended on 31.3.2012. The accounts were approved on 30.6.2012. The loss from earthquake is estimated at ₹ 30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

Solution

Para 8.3 of AS 4 "Contingencies and Events Occurring after the Balance Sheet Date", states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.2012. Therefore, loss occurred due to earthquake is not to be recognised in the financial year 2011-2012.

However, according to para 8.6 of the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the earthquake has caused major destruction; therefore fundamental accounting assumption of going concern is called upon. Hence, the fact of earthquake together with an estimated loss of ₹ 30 lakhs should be disclosed in the Report of the Directors for the financial year 2011-2012.

Illustration 3

A company has filed a legal suit against the debtor from whom ₹ 15 lakh is recoverable as on 31.3.2012. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 2012. Can the company provide for full amount of ₹ 15 lakhs as provision for doubtful debts? Discuss in detail.

Solution

As per 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, company should make the provision for doubtful debts, as legal suit has been filed on 31st March, 2012 and the chances of recovery from the suit are not good. Though, the actual result of legal suit will be known in future yet situation of non-recovery from the debtors exists before finalisation of financial statements. Therefore, provision for doubtful debts should be made for the year ended on 31st March, 2012.

Illustration 4

During the year 2012-2013, Raj Ltd. was sued by a competitor for ₹ 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of ₹ 10 lakhs in its financial statements for the year ended 31st March, 2013. On 18th May, 2013, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of ₹ 14 lakhs. The financial statements were prepared by the company's management on 30th April, 2013, and approved by the board on 30th May, 2013.

Solution

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 that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 2012-13 for which the provision was also made by it, the decision of the Court on 18th May, 2013, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Had the judgment of the Court been delivered on 1st June, 2013, it would be considered as post reporting period i.e. event ocurred after the approval of the financial statements. In that case, no adjustment in the financial statements of 2012-13 would have been required.

2.2 AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

The items of income/gains and expenses/losses recognised in a statement of profit and loss differ in financial implications. Some of them can be irregular, e.g. profit/loss on disposal of fixed assets, some can be rare, e.g. losses on fire, some can be adjustments for prior period errors. There can also be certain items reflecting changes in accounting policies and estimates, rather than an actual transaction. Financial implications of these are not same. For example, one can reasonably expect profit / loss from ordinary activities like purchases and sale of goods by a trader, to recur in future. This is definitely not true for profit/loss on disposal of fixed assets.

Accounting standard 5, prescribes classification and disclosure requirements for items of income/gains and expenses/losses recognised in a statement of profit and loss.

For the purpose, AS 5 puts items recognised in statements of profit and loss in six broad groups, namely :-

(i) Ordinary

(ii) Ordinary but exceptional

(iii) Extra-ordinary

(iv) Prior period items

(v) Changes in accounting policies

(vi) Changes in accounting estimates.

The presentation and disclosure requirements are such that special nature of an item is apparent to the reader of financial statement.

By setting a uniform basis of preparation and presentation of statements of profit and loss, the AS 5 improves comparability financial statements of same enterprise of different accounting periods and of different enterprises for same accounting period.

The standard is mandatory and applies to all enterprises.

Definitions

The following terms are used in this Statement with the meanings specified:

- ***Ordinary activities*** are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

- ***Extraordinary items*** are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.
- ***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.
- ***Accounting policies*** are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

The important requirements regarding different items are as below:

Ordinary Activities

Where income or expenses arise out of ordinary activities but are of exceptional size, nature or incidence, they should be disclosed as separate line item in the statement of profit and loss. (Paragraph 12).

Circumstances, which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12, include**:**

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions

Extraordinary Items

- The extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period.
- The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. (Paragraph 8)

- Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.
- Examples of events or transactions that generally give rise to extraordinary items for most enterprises are attachment of property of the enterprise; or an earthquake.

Prior Period Items

- 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. (Paragraph 15)
- The term 'prior period items', as defined in this Statement, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.
- The prior period items are normally included in determination of net profit or loss for the current period. Alternatively, where the prior period items are not taken in computation of current profit, they can be added (or deducted as the case may be) from the current profit In either case, the disclosure should be such as to clearly show the effects of such items. (Paragraph 19)

Changes in Accounting Estimates

- The students are aware that many items of financial statements, e.g. provision for doubtful debts and useful lives, are estimates rather than precise measures.
- As per paragraph 23 of the standard, the change in accounting estimate should be included in the determination of net profit or loss in:
  - the period of change, if the change affects the period only; or
  - the period of change and the future periods, if the change affects both.

- A change in estimate for doubtful debts affects current period only, while a change in estimated working life of a depreciable asset affects current as well as future periods.
- 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. (Paragraph 25)
- If the change of accounting estimate affects an item previously classified as extraordinary item, the effect of change should also be taken as extraordinary item.
- The nature and amount of change in accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed. (Paragraph 27)

Illustration 5

An extract from the statement profit and loss of a company for 2012-13 is given below:

	₹ 000	*₹ 000*
Sales		*3,000*
Opening stock	*500*	
Production cost	*2,800*	
	3,300	
Less: Closing Stock	*(600)*	*(2,700)*
Gross Profit		*300*
Expenses		*(250)*
Profit before tax		*50*
Tax		*20*
Profit after tax		*30*

The closing stock includes stock damaged in a fire in 2011-12. On 31/03/12, the estimated net realisable value of this stock was ₹ 15,000. The revised estimate of net realisable value of the damaged stock included in closing stock of 2012-13 is ₹ 5,000.

Rewrite the statement of profit and loss if necessary to comply with requirements of AS 5.

Solution

The fall in estimated net realisable value of damaged stock ₹ 10,000 is the effect of change in accounting estimate. As per paragraph 25 of the standard, 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.

The difference between cost of the stock and its net realisable value after fire was presumably classified as loss on fire in 2011-12. The loss on fire is an extraordinary item. Since paragraph 25 does not permit change in classification, the fall in net realisable value of damaged stock ₹ 10,000 should be classified as extra ordinary item in 2011-12 as well.

Paragraph 8 of the standard requires the extraordinary items to be disclosed in such manner that their impact on current profit or loss can be perceived. To comply with this requirement, enterprises should present profit/loss before and after extraordinary items.

	₹ 000	₹ 000
Sales		3,000
Opening stock (500 – 15)	485	
Production cost	2,800	
	3,285	
Less: Closing Stock (600 – 5)	(595)	(2,690)
Gross Profit		310
Expenses		250
Profit before loss on fire		60
Less: Loss on fire		(10)
Profit before tax		50
Tax		20
Profit after tax		30

Accounting Policies

- These are specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.
- A change in accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.
- As per paragraph 32 of the standard, any material effect of change in accounting policy should be disclosed in the financial statement. The impact of, and the adjustments resulting from such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change.
- Where the effect of change in accounting policy is not ascertainable, the fact should be indicated.

- Where the change does not have any material effect in current period, but is reasonably expected to materially affect the later periods, the fact of change should be appropriately disclosed in the current period.
- As per paragraph 22 of the standard, sometimes it is difficult to distinguish between change in accounting policy and change in accounting estimate. In such cases the change is treated as change in accounting estimate, with appropriate disclosure.

Illustration 6

The company finds that the stock sheets of 31.3.2012 did not include two pages containing details of inventory worth ₹ 20 lakhs. State, how will you deal with this matter in the accounts of A Ltd., for the year ended 31st March, 2013 with reference to AS 5.

Solution

As per para 16 of AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', omission of two pages containing details of inventory worth ₹ 20 lakhs in 31.3.2012 is a prior period item. As per para 19 of the standard, prior period items are normally included in the determination of net profit or loss for the current period. Accordingly, ₹ 20 lakhs must be added to opening stock of 1.4.2012. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Illustration 7

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

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

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

Solution

As per para 31 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

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

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

2.3 AS 11: The Effects of Changes in Foreign Exchange Rates

AS 11, (revised 2003), came into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

Scope

This Statement should be applied

(a) In accounting for transactions in foreign currencies.

(b) In translating the financial statements of foreign operations.

(c) This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

This Statement does not

(a) Specify the currency in which an enterprise presents its financial statements.

(b) Deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation.

(c) Deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) Buys or sells goods or services whose price is denominated in a foreign currency.

(b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.

(c) Becomes a party to an unperformed forward exchange contract or

(d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

Definitions

The following terms are used in this Statement with the meanings specified:

- ***Average rate*** is the mean of the exchange rates in force during a period.
- ***Closing rate*** is the exchange rate at the balance sheet date.

- ***Exchange difference*** is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.
- ***Exchange rate*** *is* the ratio for exchange of two currencies.
- ***Fair value*** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
- ***Foreign currency*** *is* a currency other than the reporting currency of an enterprise.
- ***Foreign operation*** is a subsidiary, associates, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.
- ***Forward exchange contract*** means an agreement to exchange different currencies at a forward rate.
- ***Forward rate*** is the specified exchange rate for exchange of two currencies at a specified future date.
- ***Integral foreign operation*** is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.
- ***Monetary items*** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.
- ***Net investment*** in a non-integral foreign operation is the reporting enterprise's share in the net assets of that operation.
- ***Non-integral foreign operation*** is a foreign operation that is not an integral foreign operation.
- ***Non-monetary items*** are assets and liabilities other than monetary items.
- ***Reporting currency*** is the currency used in presenting the financial statements.

Initial Recognition

A foreign currency transaction on initial recognition should be recorded by applying the foreign currency at the date of the transaction. A rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

- ***Monetary items*** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables.

- ***Non-monetary items*** are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares.

At each balance sheet date

(a) Foreign currency monetary items should be reported using the closing rate. 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, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate 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.

(b) Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.

(c) Non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

(d) The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

Recognition of Exchange Differences

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

However, exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised. Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction.

When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period.

When the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Note:

Central Government in consultation with National Advisory Committee on Accounting Standards made an amendment to AS 11 "The Effects of Changes in Foreign Exchange Rates" in the form of Companies (Accounting Standards) Amendment Rules, 2009 and 2011.

According to the recent Notification, 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, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods) but not beyond 31st March, 2020.

Ministry of Corporate Affairs vide its notification number G.S.R 913(E), dated 29th December, 2011, has amended the para 46 of AS 11 of the Companies (Accounting Standards) Amendment Rules, 2011. Through this notification, the MCA has extended the option (for the enterprises) to capitalize the exchange differences arising on reporting of long term foreign currency monetary items till 31st March, 2020 instead of 31st March, 2012. Thus the treatment availed at the option of the company shall be irrevocable and shall be exercised till 31st March, 2020.

Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option shall be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

If the above option is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

Insertion of para 46A in Accounting Standard 11 of the Companies (Accounting Standards) Rules, 2006

Ministry of Corporate Affairs vide its notification number G.S.R 914(E), dated 29th December, 2011, inserted under-mentioned para 46A in AS 11 of the Companies (Accounting Standards) Rules, 2006, now known as Companies (Accounting Standards) (Second Amendment) Rules, 2011.

"46A. (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital assets, can be added to or deducted from the cost of the assets and shall be depreciated over the balance life of the assets, and in other cases, 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 assets or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability.

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Note: The principal regulations were published in the Gazette of India Extraordinary, Part II, Section 3, Sub Section (i) vide G.S.R 739(E), dated the 7th December, 2006 and amended vide notification number G.S.R. 212(E), dated the 27th March, 2008 and subsequently amended by No. G.S.R. 225(E) dated 31st March, 2009 and No. G.S.R. 378(E), dated 11th May, 2011.

The Ministry has received several representations from industry associations that Para 6 of AS 11 and Para 4(e) of AS 16 are posing problems in proper implementation of Para 46A of AS 11 inserted vide notification 914(E) dated 29.12.2011. In order to resolve the problems faced by industry, MCA had further clarified vide Circular No. 25/2012 dated 09.08.2012 that Para 6 of AS 11 and Para 4(e) of the AS 16 shall not apply to a company which is applying clause Para 46A of AS 11.

Illustration 8

Kalim Ltd. borrowed US$ 4,50,000 on 01/01/2012, which will be repaid as on 31/07/2012. X Ltd. prepares financial statement ending on 31/03/2012. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/2012 1 US$ = ₹ 48.00
31/03/2012 1 US$ = ₹ 49.00
31/07/2012 1 US$ = ₹ 49.50

Solution

Journal Entries in the Books of Kalim Ltd.

Date	Particulars		₹ (Dr.)	₹ (Cr.)
Jan. 01, 2012	Bank Account (4,50,000 x 48)	Dr.	216,00,000	
	To Foreign Loan Account			216,00,000
Mar. 31, 2012	Foreign Exchange Difference Account	Dr.	4,50,000	
	To Foreign Loan Account [4,50,000 x(49-48)]			4,50,000
Jul. 01, 2012	Foreign Exchange Difference Account [4,50,000x(49.5-49)]	Dr.	2,25,000	
	Foreign Loan Account	Dr.	220,50,000	
	To Bank Account			2,22,75,000

Foreign operation is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

- ***Integral foreign operation*** is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations.

  Translation of Foreign Integral Operations

  (a) The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

  (b) The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation.

  (c) The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net

realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

- ***Non-integral foreign operation*** is a foreign operation that is not an integral foreign operation. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

a The assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

b Income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

c All resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.

d For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.

e Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate.

f A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

g The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary. However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.

h When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise.

i The exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

j An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

a While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.

b Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.

c The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.

d Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.

e The foreign operation's sales are mainly in currencies other than the reporting currency.

f Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.

g Sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.

h There is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

Change in the classification of a Foreign Operation

- When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve.
- When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

Illustration 9

Opportunity Ltd. purchased an equipment costing ₹ 24,00,000 lakhs on 1.4.2013 and the same was fully financed by foreign currency loan (US Dollars) payable in four annual equal installments. Exchange rates were 1 Dollar = ₹ 60.00 and ₹ 62.50 as on 1.4.2013 and 31.3.2014 respectively. First installment was paid on 31.3.2014. The entire difference in foreign exchange has been capitalized. You are required to state that how these transactions would be accounted for.

Solution

As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, should be recognized as income or expenses in the period in which they arise. Thus, exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets will be recognized as income or expense.

Calculation of Exchange Difference:

Foreign currency loan =	₹ 24,00,000/60 = 40,000 US Dollars
Exchange difference =	40,000 US Dollars × (62.50-60.00) = ₹ 1,00,000
(including exchange loss on payment of first instalment)	

Therefore, entire loss due to exchange differences amounting ₹ 1,00,000 should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not availed the option for capitalization of exchange difference as per para 46/ 46A of AS 11.

However, as per para 46A of the standard, the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, in case Opportunity Ltd. opts for capitalizing the exchange difference, then the entire amount of exchange difference of ₹ 1,00,000 will be capitalized to 'Equipment account'. This capitalized exchange difference will be depreciated over the useful life of the asset.

Cost of the asset on the reporting date

Initial cost of Equipment	₹ 24,00,000
Add: Exchange difference as on 31.3.2014	₹ 1,00,000
Total cost on the reporting date	₹ 25,00,000

Illustration 10

A business having the Head Office in Kolkata has a branch in UK. The following is the trial balance of Head Office and Branch as at 31.03.2013:

Account Name		*Amount in £*
	Dr.	*Cr.*
Fixed Assets (Purchased on 01.04.2010)	*5,000*	
Debtors	*1,600*	
Opening Stock	*400*	
Goods received from Head Office Account	*6,100*	
(Recorded in HO books as ₹ 4,02,000)		
Sales		*20,000*
Purchases	*10,000*	
Wages	*1,000*	
Salaries	*1,200*	
Cash	*3,200*	
Remittances to Head Office (Recorded in HO books as ₹ 1,91,000)	*2,900*	
Head Office Account (Recorded in HO books as ₹ 4,90,000)		*7,400*
Creditors		*4,000*

- *Closing stock at branch is £ 700 on 31.03.2013.*
- *Depreciation @ 10% p.a. is to be charged on fixed assets.*
- *Prepare the trial balance after been converted in Indian Rupees.*
- *Exchange rates of Pounds on different dates are as follow:*

  01.04.2010– ₹ 61; 01.04.2012– ₹ 63 & 31.03.2013 – ₹ 67

Solution

Trial Balance of the Foreign Branch converted into Indian Rupees as on March 31, 2013

Particulars	£ (Dr.)	£ (Cr.)	Conversion Basis	₹ (Dr.)	₹ (Cr.)
Fixed Assets	5,000		Transaction Date Rate	3,05,000	
Debtors	1,600		Closing Rate	1,07,200	
Opening Stock	400		Opening Rate	25,200	
Goods Received from HO	6,100		Actuals	4,02,000	
Sales		20,000	Average Rate		13,00,000
Purchases	10,000		Average Rate	6,50,000	
Wages	1,000		Average Rate	65,000	
Salaries	1,200		Average Rate	78,000	
Cash	3,200		Closing Rate	2,14,400	
Remittance to HO	2,900		Actuals	1,91,000	
HO Account		7,400	Actuals		4,90,000
Creditors		4,000	Closing Rate		2,68,000
Exchange Rate Difference			Balancing Figure	20,200	
	31,400	31,400		20,58,000	20,58,000
Closing Stock	700		Closing Rate	46,900	
Depreciation	500		Fixed Asset Rate	30,500	

- **Forward exchange contract** means an agreement to exchange different currencies at a forward rate.
- **Forward rate** is the specified exchange rate for exchange of two currencies at a specified future date.
- An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction.

- The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract.
- Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change.
- Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.
- In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Illustration 11

Rau Ltd. purchased a plant for US$ 1,00,000 on 01st February 2012, payable after three months. Company entered into a forward contract for three months @ ₹ 49.15 per dollar. Exchange rate per dollar on 01st Feb. was ₹ 48.85. How will you recognize the profit or loss on forward contract in the books of Rau Ltd.

Solution

Forward Rate	₹ 49.15
Less: Spot Rate	(₹ 48.85)
Premium on Contract	₹ 0.30
Contract Amount	US$ 1,00,000
Total Loss (1,00,000 x 0.30)	₹ 30,000

Contract period 3 months

Two falling the year 2012-13; therefore loss to be recognized (30,000/3) x 2 = ₹ 20,000.Rest ₹ 10,000 will be recognized in the following year.

Illustration 12

Mr. A bought a forward contract for three months of US$ 1,00,000 on 1st December at 1 US$ = ₹ 47.10 when exchange rate was US$ 1 = ₹ 47.02. On 31st December when he closed his books exchange rate was US$ 1 = ₹ 47.15. On 31st January, he decided to sell the contract at ₹ 47.18 per dollar. Show how the profits from contract will be recognized in the books.

Solution

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

Sale Rate	₹ 47.18
Less: Contract Rate	(₹ 47.10)
Premium on Contract	₹ 0.08
Contract Amount	US$ 1,00,000
Total Profit (1,00,000 x 0.08)	₹ 8,000

Disclosure

An enterprise should disclose:

a. The amount of exchange differences included in the net profit or loss for the period.

b. Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

Presentation of Foreign Currency Monetary Item Translation Difference Account (FCMITDA)

In the Revised Schedule VI (now Schedule III to the Companies Act, 2013) format, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". Therefore, the Council of the Institute at its 324th meeting held on March 24-26, 2013 at New Delhi, considered the issue regarding the presentation of the FCMITDA in the balance sheet.

The Council considered the definition of an asset given in the Framework on Preparation and Presentation of Financial Statements issued by ICAI which states as follows:

"An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

Since the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Therefore, such balance cannot be reflected as an asset.

Accordingly, the Council decided that debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

Paragraphs 46 for entities other than Companies

46 (1) In respect of accounting periods commencing on or after 7th December, 2006 (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, 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 or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Illustration 13

Option Ltd. is engaged in the manufacturing of steel. For its steel plant, it required machineries of latest technology. It usually resorts to Long Term Foreign Currency Borrowings for its fund requirements. On 1st April, 2011, it borrowed US $1 million from International Funding Agency, USA when exchange rate was 1 $ = ₹ 52. The funds were used for acquiring machineries on the same date to be used in three different steel plants. The useful life of the machineries is 10 years and their residual value is ₹ 20,00,000.

Earlier also the company used to purchase machineries out of foreign borrowings. The exchange differences arising on such borrowings were charged to profit and loss account and were not capitalized even though the company had an option to capitalize it as per notified AS 11 (notification issued by the MCA in 2009).

Now for this new purchase of machinery, Option Ltd, is interested to avail the option of capitalizing the same to the cost of asset. Exchange rate on 31st March, 2012 is 1 US $ = ₹ 51. Assume that on 31st March, 2012, Option Ltd. is not having any old Long term foreign currency borrowings except for the amount borrowed for machinery purchased on 1st April, 2011.

Can Option Ltd. capitalize the exchange difference to the cost of asset on 31st March, 2012? If yes, then calculate the depreciation amount on machineries as on 31st March, 2012.

Solution

Ministry of Corporate Affairs, Government of India, inserted paragraph 46A in notified AS 11 by Notification dated 29th December, 2011, which is relevant for companies. It states that in respect of accounting periods commencing on or after 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 or not (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, though Option Ltd. had not earlier exercised the option as given by the notification on AS 11, issued in 2009, yet it can avail the option to capitalise the exchange difference to the cost of machinery by virtue of para 46A inserted in the notified AS 11 in December, 2011.

Exchange difference to be capitalised

Cost of the asset in $		$ 10 lakhs
Exchange rate on 1st April, 2011		₹ 52 = 1$
Cost of the asset in ₹	($ 10 lakhs x ₹ 52)	520 lakhs
Less: Exchange differences as on 31st March, 2012 (52-51) x $ 1 million	(Gain)	(10 lakhs)
		510 lakhs
Less: Depreciation for 2011-12	(510 lakhs - 20 lakhs)/10 years	(49 lakhs)
		461 lakhs

Change in classification of a significant foreign operation

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

a. The nature of the change in classification;

b. The reason for the change;

c. The impact of the change in classification on shareholders' funds; and

d. The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

2.4 AS 12 : Accounting for Government Grants

The Standard came into effect in respect of accounting periods commencing on or after 1.4.1992 and is mandatory for all entities.

Introduction

(a) This Standard deals with accounting for government grants. Government grants are sometimes called by other names such as subsidies, cash incentives, duty drawbacks, etc.

(b) This Standard does not deal with

  (i) The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.

  (ii) Government assistance other than in the form of government grants.

  (iii) Government participation in the ownership of the enterprise.

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment

Capital Approach versus Income Approach

Two broad approaches may be followed for the accounting treatment of government grants namely: the *'capital approach'*, under which a grant is treated as part of shareholders' funds, and the *'income approach'*, under which a grant is taken to income over one or more periods.

Those in support of the 'capital approach' argue as follows:

i. Many government grants are in the nature of promoters' contribution, i.e., they are given by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants.

ii. They are not earned but represent an incentive provided by government without related costs.

Arguments in support of the 'income approach' are as follows:

i. The enterprise earns grants through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

ii. As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

iii. In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

In most cases, the periods over which an enterprise recognizes the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

Recognition of Government Grants

Government grants available to the enterprise are considered for inclusion in accounts:

i. Where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

ii. Where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

Mere receipt of a grant is not necessarily conclusive evidence that conditions attaching to the grant have been or will be fulfilled.

Non-monetary Government Grants

Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

Presentation of Grants Related to Specific Fixed Assets

Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives.

Method I :

- The grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value.
- The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.
- Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Illustration 14

Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for ₹ 10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant amount is deducted from the value of fixed asset.

Solution

Journal in the books of Z Ltd.

Year	Particulars		₹ (Dr.)	₹ (Cr.)
1st	Fixed Assets Account	Dr.	50,00,000	
	To Bank Account			50,00,000
	(Being Fixed Assets purchased)			
	Bank Account	Dr.	10,00,000	
	To Fixed Assets Account			10,00,000
	(Being grant received from the government)			
	Depreciation Account	Dr.	7,00,000	
	To Fixed Assets Account			7,00,000
	(Being Depreciation charged on SLM)			
	Profit & Loss Account	Dr.	7,00,000	
	To Depreciation Account			7,00,000
	(Being Depreciation transferred to P/L Account)			
2nd	Depreciation Account	Dr.	7,00,000	
	To Fixed Assets Account			7,00,000
	(Being Depreciation charged on SLM)			
	Profit & Loss Account	Dr.	7,00,000	
	To Depreciation Account			7,00,000
	(Being Depreciation transferred to P/L Account)			

Method II:

- Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.
- Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets.

- If a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income.

Illustration 15

Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for ₹ 10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant is treated as deferred income.

Solution

Journal in the books of Z Ltd.

Year	Particulars		₹ (Dr.)	₹ (Cr.)
1st	Fixed Assets Account	Dr.	50,00,000	
	To Bank Account			50,00,000
	(Being fixed assets purchased)			
	Bank Account	Dr.	10,00,000	
	To Deferred Government Grant Account			10,00,000
	(Being grant received from the government)			
	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being depreciation transferred to P/L Account)			
	Deferred Government Grants Account	Dr.	2,00,000	
	To Profit & Loss Account			2,00,000
	(Being proportionate government grant taken to P/L Account)			
2nd	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being depreciation transferred to P/L Account)			

	Deferred Government Grant Account Dr.	2,00,000	
	To Profit & Loss Account		2,00,000
	(Being proportionate government grant taken to P/L Account)		

Presentation of Grants Related to Revenue

Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

Presentation of Grants of the nature of Promoters' contribution

Where the government grants are of the nature of promoters' contribution, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Refund of Government Grants

- Government grants sometimes become refundable because certain conditions are not fulfilled and are treated as an extraordinary item (AS 5).
- The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.
- The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable.
- Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

Illustration 16

Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for ₹ 10 lakhs. Grant was considered as refundable in the end of 2nd year to the extent of ₹ 7,00,000. Pass the journal entry for refund of the grant as per the first method.

Solution

Fixed Assets Account Dr.	₹7,00,000	
To Bank Account		₹7,00,000
(Being government grant on asset refunded)		

Disclosure

i. The accounting policy adopted for government grants, including the methods of presentation in the financial statements;

ii. The nature and extent of government grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

Illustration 17

A fixed asset is purchased for ₹ 20 lakhs. Government grant received towards it is ₹ 8 lakhs. Residual Value is ₹ 4 lakhs and useful life is 4 years. Assume depreciation on the basis of Straight Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of ₹ 5 lakhs due to non compliance with certain conditions. Pass journal entries for first two years.

Solution

Journal Entries

Year	*Particulars*		*₹ in lakhs (Dr.)*	*₹ in lakhs (Cr.)*
1	Fixed Asset Account	Dr.	20	
	To Bank Account			20
	(Being fixed asset purchased)			
	Bank Account	Dr.	8	
	To Fixed Asset Account			8
	(Being grant received from the government reduced the cost of fixed asset)			
	Depreciation Account (W.N.1)	Dr.	2	
	To Fixed Asset Account			2
	(Being depreciation charged on Straight Line method (SLM))			
	Profit & Loss Account	Dr.	2	
	To Depreciation Account			2
	(Being depreciation transferred to Profit and Loss Account at the end of year 1)			
2	Fixed Asset Account	Dr.	5	
	To Bank Account			5

	(Being government grant on asset partly refunded which increased the cost of fixed asset)			
	Depreciation Account (W.N.2)	Dr.	3.67	
	To Fixed Asset Account			3.67
	(Being depreciation charged on SLM on revised value of fixed asset prospectively)			
	Profit & Loss Account	Dr.	3.67	
	To Depreciation Account			3.67
	(Being depreciation transferred to Profit and Loss Account at the end of year 2)			

Working Notes:

1. Depreciation for Year 1

	₹ *in lakhs*
Cost of the Asset	20
Less: Government grant received	(8)
	12
Depreciation $\left[\frac{12-4}{4}\right]$	2

2. Depreciation for Year 2

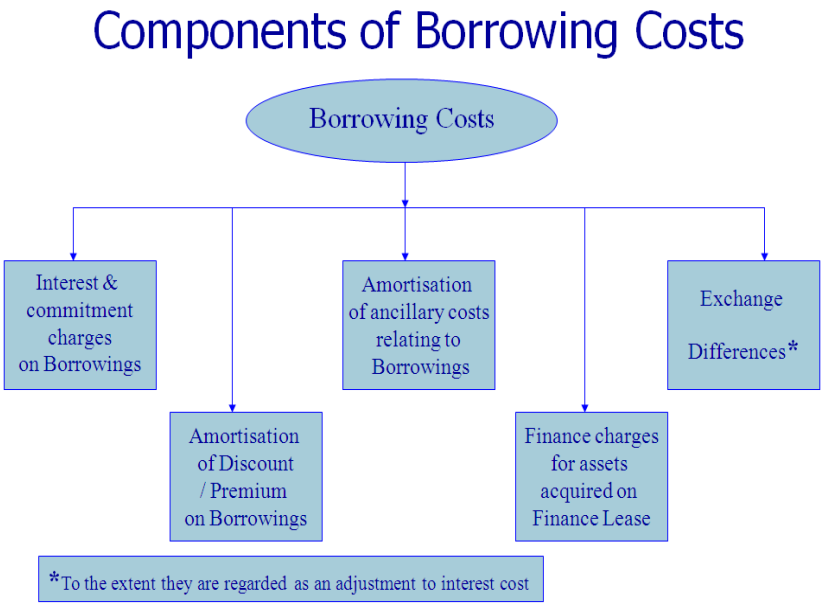
	₹ *in lakhs*
Cost of the Asset	20
Less: Government grant received	(8)
	12
Less: Depreciation for the first year $\left[\frac{12-4}{4}\right]$	2
	10
Add: Government grant refundable	5
	15
Depreciation for the second year $\left[\frac{15-4}{3}\right]$	3.67

2.5 AS 16 : Borrowing Costs

This Standard came into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature.

It does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.



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

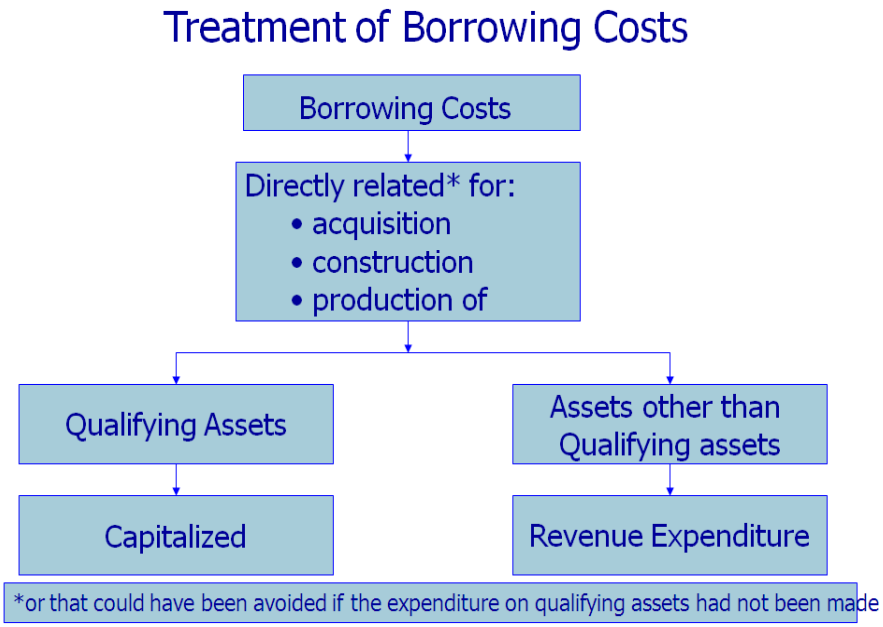
Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Accounting standard further clarifies the meaning of the expression 'substantial period of time'. According to it, substantial period of time primarily depends on the facts and circumstances of each case. It further states that, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case. In estimating the period, time which an asset takes

technologically and commercially target if ready for its intended use or sale should be considered.

Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation



The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

Commencement of Capitalisation

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

a. **Expenditure for the acquisition, construction or production of a qualifying asset is being incurred**: Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

b. **Borrowing costs are being incurred**.

c. **Activities that are necessary to prepare the asset for its intended use or sale are in progress**: The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place.

Suspension of Capitalisation

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its

intended use or sale. For example: capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

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

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. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts.

Disclosure

The financial statements should disclose:

a. The accounting policy adopted for borrowing costs; and

b. The amount of borrowing costs capitalised during the period.

Illustration 18

An industry borrowed ₹ 40,00,000 for purchase of machinery (a qualifying asset) on 1.6.2011. Interest on loan is 9% per annum. The machinery was put to use from 1.1.2012. Pass journal entries for the year ended 31.3.2012 to record the borrowing cost of loan, as per AS 16.

Solution

		₹
Interest upto 31.3.2012 (40,00,000 × 9% × $\frac{10}{12}$ months)	=	3,00,000
Less: Interest relating to pre-operative period 3,00,000 × $\frac{7}{10}$	=	(2,10,000)
Amount to be charged to P&L A/c	=	90,000
Pre-operative interest to be capitalized	=	2,10,000

Journal Entries

		₹	₹
Machinery A/c	Dr.	2,10,000	

To Loan A/c			2,10,000
(Being interest on loan for pre-operative period capitalized)			
Interest on loan A/c	Dr.	90,000	
To Loan A/c			90,000
(Being the interest on loan for the post-operative period)			
Profit and Loss A/c	Dr.	90,000	
To Interest on loan A/c			90,000
(Being interest on loan transferred to P&L A/c)			

Illustration 19

X Ltd. began construction of a new building on 1st January, 2012. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 2012 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	*Rate of Interest*
₹ 5,00,000	*11%*
₹ 9,00,000	*13%*

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

		₹
January	*2012*	*2,00,000*
April	*2012*	*2,50,000*
July	*2012*	*4,50,000*
December	*2012*	*1,20,000*

Building was completed by 31st December, 2012. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Answer

(i) Computation of average accumulated expenses

		₹
₹ 2,00,000 x 12 / 12	=	2,00,000
₹ 2,50,000 x 9 / 12	=	1,87,500
₹ 4,50,000 x 6 / 12	=	2,25,000
₹ 1,20,000 x 1 / 12	=	10,000
		6,22,500

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

Amount of loan (₹)	Rate of interest		Amount of interest (₹)
5,00,000	11%	=	55,000
9,00,000	13%	=	1,17,000
14,00,000			1,72,000
Weighted average rate of interest $\left(\frac{1,72,000}{14,00,000}\times 100\right)$		=	12.285% (approx)

(iii) Interest on average accumulated expenses

		₹
Specific borrowings (₹ 1,00,000 x 10%)	=	10,000
Non-specific borrowings (₹ 5,22,500* x 12.285%)	=	64,189
Amount of interest to be capitalized	=	74,189

(iv) Total expenses to be capitalized for building

	₹
Cost of building ₹ (2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	74,189
	10,94,189

(v) Journal Entry

Date	Particulars		Dr. (₹)	Cr. (₹)
31.12.2012	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalized)			

Illustration 20

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2013-14. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹ 50 lakhs. As on 31st March, 2014, since the said project was not complete, the directors of Take Ltd. resolved to capitalize the

* (₹ 6,22,500 – ₹ 1,00,000)

interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment.

Solution

Cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 2014.

2.6 AS 19 : Leases

Introduction

A *Lease* is an agreement whereby the Lessor *(owner of an asset)* conveys to the Lessee (another party) in return for a payment or series of periodic payments (Lease rents), the right to use an asset for an agreed period of time. The leasing may in effect be same as hire purchase because the ownership of the asset can be transferred to the lessee for a small sum at the termination of lease agreement. Prior to issuance of the Accounting Standard (AS) 19, Leases, by the Institute of Chartered Accountants of India, all leases were treated as a mode of off-balance sheet finance. This allowed enterprises not to recognise assets taken on lease in their balance sheets and thus to understate their net assets and capital employed and consequently to overstate their return on investment (ROI). The Accounting Standard (AS) 19, Leases, has reduced the scope of this kind of window dressing by requiring enterprises to recognise assets taken on certain types of leases, called finance leases. The finance leases are those, in which risks and rewards of ownership are substantially transferred from the lessor to lessee.

The policy of recognition of assets taken on finance lease is an example of principle of 'substance over form' described in paragraph 17 of Accounting Standard (AS) 1, Disclosure of Accounting Policies. By the principle of 'substance over form' in selecting accounting policies, enterprises are required to give precedence to substance of a transaction over its legal form. In case of finance leases, the lessee, despite not being legal owner, effectively enjoys all rights and accepts all liabilities, usually attached with ownership. It is therefore rational for the lessee to recognise the assets taken on finance leases as assets in its books.

Applicability of Accounting Standard

The Accounting Standard (AS) 19, Leases came into effect in respect of all assets leased during accounting periods commencing on or after April 1, 2001 and was declared mandatory from that date. The standard applies to all enterprises. The Level II and Level III entities are however exempted from making certain disclosures. (See the Scheme for Applicability of Accounting Standards) Any enterprise that does not make disclosures in pursuance of this exemption, should disclose that fact.

The standard applies to all leases other than: (Paragraph 1, AS 19)

(a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and

(b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and

(c) lease agreements to use lands

(d) agreements that are contracts for services, that do not transfer right to use assets from one contracting party to the other.

Types of leases

For accounting purposes, leases are classified as:

(i) Finance leases; and

(ii) Operating leases.

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

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

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term; (these situations may commonly arise in hire purchase)

(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; (Under US GAAP, a threshold limit of 75% or more of economic life is set. See details at the end of chapter)

(d) At the inception of the lease, present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; (Under US GAAP, a threshold limit of 90% or more of fair value is set. See details at the end of chapter) and

(e) The leased asset is of a specialized nature such that only the lessee can use it without major modifications being made.

Indicators of Finance Lease

(a) If the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee;

(b) If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease); and

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

Lease Payments

Lease payments may consist of specified periodic payments, called lease rents and a terminal payment, called the guaranteed residual value. Together, these payments are called the minimum lease payments. The excess of expected residual value over the guaranteed residual value is the unguaranteed residual value. Contingent rents are lease payments based on a factor other than passage of time, e.g. percentage sales, amount of usage etc.

Accounting for Finance Leases (Books of lessee)

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

(i) On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:

- Fair value of leased asset
- Present value of minimum lease payments (present value to be calculated with discount rate equal to interest rate implicit in the lease)

(ii) Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

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

(iv) Charge depreciation on leased asset on the same lines as any other asset. If there is not certainity that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term.

Computation of interest rate implicit on lease

Discounting rate = R% p.a;

Lease Rents = L_1, L_2 …… L_n (Payable annually, at the end of each year)

Lease period = n years;

Guaranteed residual value = GR;

Unguaranteed residual value = UGR

Fair Value at the inception (beginning) of lease = FV

$$\text{PV of MLP} = \frac{L_1}{(1+R)^1} + \frac{L_2}{(1+R)^2} + \frac{L_n}{(1+R)^n} + \frac{GR}{(1+R)^n}$$

$$\text{Present value of unguaranteed residual value} = \frac{UGR}{(1+R)^n}$$

If interest rate implicit on lease is used as discounting rate:

Fair Value = PV of Minimum Lease Payments + PV of unguaranteed residual value ….. (1)

The interest rate implicit on lease can be computed by trial and error, provided the information required, e.g. the unguaranteed residual value can be reasonably ascertained.

Example 1

Annual lease rents = *₹ 50,000 at the end of each year.*

Lease period = *5 years;*

Guaranteed residual value = *₹ 25,000*

Unguaranteed residual value = *₹ 15,000*

Fair Value at the inception (beginning) of lease = *₹ 2,00,000*

Interest rate implicit on lease is computed below:

Interest rate implicit on lease is a discounting rate at which present value of minimum lease payments and unguaranteed residual value is ₹ 2 lakhs.

PV of minimum lease payments and unguaranteed residual value at guessed rate 10%

Year	*Lease Payments* ₹	*DF (10%)*	*PV* ₹
1	*50,000*	*0.909*	*45,450*
2	*50,000*	*0.826*	*41,300*
3	*50,000*	*0.751*	*37,550*
4	*50,000*	*0.683*	*34,150*

5	*50,000*	*0.621*	*31,050*
5	*25,000*	*0.621*	*15,525*
5	*15,000*	*0.621*	*9,315*
			2,14,340

PV of minimum lease payments and unguaranteed residual value at guessed rate 14%

Year	***Lease Payments*** ₹	***DF (14%)***	***PV*** ₹
1	*50,000*	*0.877*	*43,850*
2	*50,000*	*0.769*	*38,450*
3	*50,000*	*0.675*	*33,750*
4	*50,000*	*0.592*	*29,600*
5	*50,000*	*0.519*	*25,950*
5	*25,000*	*0.519*	*12,975*
5	*15,000*	*0.519*	*7,785*
			1,92,360

Interest rate implicit on lease is computed below by interpolation:

Interest rate implicit on lease = 10% + $\frac{14\% - 10\%}{2,14,340 - 1,92,360} \times (2,14,340 - 2,00,000) = 12.6\%$

Recognition of asset and liability

At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability at lower of

(i) present value of minimum lease payments and

(ii) fair value of leased asset.

The discounting rate should be interest rate implicit on lease. Where interest rate implicit on lease is not determinable, the lessee's incremental borrowing rate should be used as discounting rate. (As distinguished from rate of interest on lessee's existing loans, the incremental borrowing rate is the rate of interest at which the lessee can borrow fresh funds under terms, similar to lease arrangement.)

Where interest rate implicit on lease is determinable, the present value of minimum lease payments is determined using the interest rate implicit on lease as discounting rate. From (1) above, in such cases: PV of minimum lease payment < Fair Value. Hence, where interest rate implicit on lease is determinable, the asset and liability is recognised at PV of minimum lease payments.

Example 2

Present value of minimum lease payment using data for example 1 is computed below:

Year	MLP ₹	DF (12.6%)	PV ₹
1	50,000	0.890	44,500
2	50,000	0.790	39,500
3	50,000	0.700	35,000
4	50,000	0.622	31,100
5	50,000	0.552	27,600
5	25,000	0.552	13,800
5	15,000	0.552	8,280
			1,99,780

Present value of minimum lease payment = ₹ 1,99,780

Fair value of leased asset = ₹ 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

	₹	₹
Asset A/c Dr.	1,99,780	
To Lessor		1,99,780
(Being recognition of finance lease as asset and liability)		

Recognition of Finance Charge (Paragraph 16)

Minimum lease payments consist of finance charges and the principals. The principal components reduce the liability to the lessor. The finance charge components are recognised as expenses in the periods the lease payments are incurred. In analyzing the lease payments, a constant periodic rate of interest is used. Where the liability is recognised at present value of minimum lease payments, e.g. where interest rate implicit on lease is determinable, the rate of interest to be used for analysis of lease rents is the discounting rate. Where the liability is recognised at fair value, the rate of interest must be determined by trial and error as the discounting rate at which present value of minimum lease payments equals the fair value.

Example 3

Using data for example 1 and assuming zero residual value, allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments ₹	Finance Charge (12.6%) ₹	Principal ₹	Principal due ₹
0	--	--	--	1,91,500
1	50,000	24,129	25,871	1,65,629
2	50,000	20,869	29,131	1,36,498
3	50,000	17,199	32,801	1,03,697
4	50,000	13,066	36,934	66,763
5	75,000	8,237*	66,763	
	2,75,000	83,500	1,91,500	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

		₹	₹
Finance Charge A/c	Dr.	24,129	
To Lessor			24,129
(Being finance charge due for the year)			
Lessor	Dr.	50,000	
To Bank A/c			50,000
(Being payment of lease rent for the year)			
P & L A/c	Dr.	24,129	
To Finance Charge A/c			24,129
(Being recognition of finance charge as expense for the year)			

Example 4

In example 1, suppose unguaranteed residual value is not determinable and lessee's incremental borrowing rate is 10%.

Since interest rate implicit on lease is discounting rate at which present value of minimum lease payment and present value of unguaranteed residual value equals the fair value, interest rate implicit on lease cannot be determined unless unguaranteed residual value is known. If interest rate implicit on lease is not determinable, the present value of minimum lease payments should be determined using lessee's incremental borrowing rate.

* The difference between this figure and finance charge [66,763×12.6%=8412] is due to approximation in computation.

Present value of minimum lease payment using lessee's incremental borrowing rate 10% is computed below:

Year	MLP ₹	DF (10%)	PV ₹
1	50,000	0.909	45,450
2	50,000	0.826	41,300
3	50,000	0.751	37,550
4	50,000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
			2,05,025

Present value of minimum lease payment = ₹ 2,05,025

Fair value of leased asset = ₹ 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

		₹	₹
Asset A/c	Dr.	2,00,000	
To Lessor			2,00,000
(Being recognition of finance lease as asset and liability)			

Since the liability is recognised at fair value ₹ 2 lakh (total principal), we need to ascertain a discounting rate at which present value minimum lease payments equals ₹ 2 lakh. The discounting rate can then be used for allocation of finance charge over lease period.

PV of minimum lease payments at guessed rate 12%

Year	Minimum Lease Payments ₹	DF (12%)	PV ₹
1	50,000	0.893	44,650
2	50,000	0.797	39,850
3	50,000	0.712	35,600
4	50,000	0.636	31,800
5	50,000	0.567	28,350
5	25,000	0.567	14,175
			1,94,425

Required discounting rate = $10\% + \frac{12\% - 10\%}{2,05,025 - 1,94,425} \times (2,05,025 - 2,00,000) = 10.95\%$

Allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments ₹	Finance Charge (10.95%) ₹	Principal ₹	Principal due ₹
0	--	--	--	2,00,000
1	50,000	21,900	28,100	1,71,900
2	50,000	18,823	31,177	1,40,723
3	50,000	15,409	34,591	1,06,132
4	50,000	11,621	38,379	67,753
5	75,000	7,247*	67,753	
	2,75,000	75,000	2,00,000	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

		₹	₹
Finance Charge A/c	Dr.	21,900	
To Lessor			21,900
(Being finance charge due for the year)			
Lessor	Dr.	50,000	
To Bank A/c			50,000
(Being payment of lease rent for the year)			
P & L A/c	Dr.	21,900	
To Finance Charge			21,900
(Being recognition of finance charge as expense for the year)			

Depreciation

The depreciation policy for a leased asset should be consistent with that for depreciable assets, which are owned, and the depreciation recognised should be calculated in accordance with Accounting Standards. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its

* The difference between this figure & finance charge [67,753×10.95% = 7418] is due to approximation in computation

useful life, whichever is shorter.

Contingent Rents and other costs

Contingent rents, costs for services and taxes are recognised as expense as and when incurred.

Disclosures made by the Lessee (Paragraph 22)

The lessee should, in addition to the requirements of AS 10, Property, Plant and Equipment, and the governing statute, make the following disclosures for finance leases:

(a) assets acquired under finance lease as segregated from the assets owned;

(b) for each class of assets, the net carrying amount at the balance sheet date;

(c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

  (i) not later than one year;

  (ii) later than one year and not later than five years;

  (iii) later than five years;

(d) contingent rents recognised as expense in the statement of profit and loss for the period;

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

(f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

  (i) the basis on which contingent rent payments are determined;

  (ii) the existence and terms of renewal or purchase options and escalation clauses; and

  (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III enterprises need not make disclosures required by paragraphs 22(c), (e) and (f).

Accounting for finance leases (Books of lessor)

In a finance lease, the lessee effectively buys the leased asset sold by the lessor. The lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c. Where the lessor pays to purchase the asset for giving on finance lease, the corresponding account credited is

Bank. Where the lessor is a manufacturer or dealer, the corresponding account credited is Sales. In the later case, the difference between the sale value recognised and cost of the asset gets recognised as profit / loss on transfer to the statement of profit and loss of the period of inception of lease. (See paragraphs 26 and 32)

If discounting rate is interest rate implicit on lease, an analysis of definitions given in paragraph 3 shows that the Net Investment in Lease is fair value of leased asset.

Gross investment in Lease (GIL)

= Minimum Lease Payments (MLP) + Unguaranteed Residual value (UGR)

Minimum Lease Payments

Minimum Lease Payments (MLP) are the payments that the Lessee is to make to the Lessor, together with:

(i) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

(ii) in the case of the lessor, any residual value guaranteed to the Lessor:

- by or on behalf of the lessee;or
- by an independent third party financially capable of meeting the gurantee

Unguaranteed Residual Value

Unguaranteed Residual Value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

Gross Investment

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Net investment in Lease (NIL)

= Gross investment in Lease (GIL) – Unearned Finance Income (UFI).

Unearned finance income (UFI) = GIL – (PV of MLP + PV of UGR)

The discounting rate for the above purpose is the rate of interest implicit in the lease.

From the definition of interest rate implicit on lease:

(PV of MLP + PV of UGR) = Fair Value.

The above definitions imply that:

(a) Unearned Finance Income (UFI) = GIL – Fair Value

(b) Net Investment in Lease = GIL – UFI = GIL – (GIL – Fair Value) = Fair Value

Since the sale and receivables are recognised at net investment in lease, which is equal to fair value: Profit recognised at the inception of lease = Fair Value – Cost

Total earning of lessor = GIL – Cost

= (GIL – Fair Value) + (Fair Value – Cost)

= Unearned Finance Income + (Fair Value – Cost)

The above analysis does not hold where the discounting rate is not equal to interest rate implicit on lease. Such is the case, where the interest rate implicit on lease is artificially low. As per paragraph 32, the discounting rate in such situations should be the commercial rate of interest.

Recognition of Finance Income

The unearned finance income is recognised over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment in lease outstanding.

The constant periodic return is the rate used for discounting, i.e. either the interest rate implicit on lease or the commercial rate of interest.

Contingent Rents and Initial Direct Costs

Contingent rents, fees for services and taxes recovered from lessee are recognised as income as and when they accrue. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Review of unguaranteed residual value by lessor

Paragraph 30 requires a lessor to review unguaranteed residual value used in computing the gross investment in lease regularly. In case any reduction in the estimated unguaranteed residual value is identified, the income allocation over the remaining lease term is to be revised. Also, any reduction in respect of income already accrued is to be recognised immediately. An upward adjustment of the estimated residual value is not made.

Interest rate implicit on lease is a discount rate at which sum of present value of minimum lease payments and present value of unguaranteed residual value (both from the standpoint of lessor) is equal to fair value. A revision of unguaranteed residual value affects the interest rate implicit on lease having consequential effect on allocation of finance income. Where a commercial rate is used for discounting, a revision of unguaranteed residual value affects net investment on lease, having consequential effect on income allocation, including profit recognised at the inception of lease.

Disclosures

The lessor should make the following disclosures for finance leases:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

  (i) not later than one year;

  (ii) later than one year and not later than five years;

  (iii) later than five years;

(b) unearned finance income;

(c) the unguaranteed residual values accruing to the benefit of the lessor;

(d) the accumulated provision for uncollectible minimum lease payments receivable;

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

(f) a general description of the significant leasing arrangements of the lessor; and

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

Note: The Level II and Level III non-corporate entities need not make disclosures required by paragraphs 37(a), (f) and (g).

Accounting for Operating Leases

Operating leases are non-payout leases, i.e. an individual contract of operating lease does not usually recover the entire cost of leased asset for the lessor. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Accounting treatment in the Books of lessee

Lease payments are frequently tailor made to suit the payment capacity of the lessee. For example, a lease term may provide for low initial rents and high terminal rent. Such payment patterns do not reflect the pattern of benefit derived by the lessee from the use of leased asset. To have better matching between revenue and costs, paragraph 23 of the standard requires lessees to recognise operating lease payments as 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.

Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year 1,20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are ₹ 25,000, ₹ 45,000 and ₹ 50,000 respectively. The total lease payment *₹ 1,20,000 in this example should be recognised in proportion of output as ₹ 15,000 in year 1, ₹ 30,000 in year 2 and ₹ 75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Rent Adjustment A/c.*

The accounting entries for year 1 in books of lessee are suggested below:

		₹	₹
Lease Rent A/c	*Dr.*	*25,000*	
To Lessor			*25,000*
(Being lease rent for the year due)			
Lessor	*Dr.*	*25,000*	
To Bank A/c			*25,000*
(Being payment of lease rent for the year)			
Lease Rent Adjustment	*Dr.*	*15,000*	
P & L A/c	*Dr.*	*10,000*	
To Lease Rent A/c			*25,000*
(Being recognition of lease rent as expense for the year)			

Since total lease rent due and recognised must be same, the Lease Rent Adjustment A/c will close in the terminal year. Till then, the balance of Lease Rent Adjustment A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

Disclosures by lessees

The paragraph 25 requires lessees to make following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:

  (i) not later than one year;

  (ii) later than one year and not later than five years;

  (iii) later than five years;

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

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III non-corporate entities need not make disclosures required by paragraphs 25(a), (b) and (e).

Accounting treatment in the books of lessor

(i) Paragraph 39 requires a lessor to treat assets given under operating leases as fixed assets in its balance sheets and

(ii) Paragraph 41 requires depreciation to be recognized in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10. (Paragraph 43)

(iii) The impairment losses on assets given on operating leases are determined and treated as per AS 28. (Paragraph 44)

A manufacturer or dealer lessor should bring the asset given on operating lease as fixed asset in their books by debiting concerned Fixed Asset A/c and crediting Cost of Production / Purchase at cost. No selling profit should be recognised on entering into operating lease, because such leases are not equivalents of sales (Paragraph 45)

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost ₹ 5,00,000. Straight-line depreciation in proportion of output is considered appropriate.

$$\text{Total lease rent} = 120\% \text{ of ₹ } 5 \text{ lakhs} \times \frac{\text{Output during lease period}}{\text{Total output}}$$

$$= \text{₹ } 6 \text{ lakhs} \times \frac{60{,}000 \text{ units}}{1{,}25{,}000 \text{ units}} = \text{₹ } 2.88 \text{ lakhs}$$

Annual lease rent = ₹ 2,88,000 / 3 = ₹ 96,000

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 10 : 20 : 30. Hence income recognised in years 1, 2 and 3 are ₹ 48,000, ₹ 96,000 and ₹ 1,44,000 respectively.

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 5 lakh should be allocated over useful life 6 years in proportion of output, i.e. in proportion of 10 : 20 : 30 : 40 : 20 : 5. Depreciation for year 1 is ₹ 40,000.

The accounting entries for year 1 in books of lessor are suggested below:

		₹	₹
Machine given on Operating Lease	Dr.	5,00,000	
To Purchase			5,00,000
(Being machine given on operating lease brought into books)			
Lessee	Dr.	96,000	
To Lease Rent			96,000
(Being lease rent for the year due)			
Bank	Dr.	96,000	
To Lessee			96,000
(Being receipt of lease rent for the year)			
Lease Rent	Dr.	96,000	
To P & L A/c			48,000
To Lease Rent Adjustment			48,000
(Being recognition of lease rent as income for the year)			
Depreciation	Dr.	40,000	
To Machine given on Operating Lease			40,000
(Being depreciation for the year)			
P & L A/c	Dr.	40,000	
To Depreciation			40,000
(Being depreciation for the year transferred to P & L A/c)			

Since total lease rent due and recognised must be same, the Lease Rent Adjustment A/c will close in the terminal year. Till then, the balance of Lease Rent Adjustment A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

Illustration 21

S. Square Private Limited has taken machinery on lease from S.K. Ltd. The information is as under:

Lease term = 4 years

Fair value at inception of lease = ₹ 20,00,000

Lease rent = ₹ 6,25,000 p.a. at the end of year

Guaranteed residual value = ₹ 1,25,000

Expected residual value = ₹ 3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19.

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	*Minimum Lease Payment ₹*	*Internal rate of return (Discount rate @5%)*	*Present value ₹*
1	6,25,000	0.8696	5,43,500
2	6,25,000	0.7561	4,72,563
3	6,25,000	0.6575	4,10,937
4	7,50,000*	0.5718	4,28,850
Total	26,25,000		18,55,850

Present value of minimum lease payments ₹ 18,55,850 is less than fair value at the inception of lease i.e. ₹ 20,00,000, therefore, the lease liability should be recognized at ₹ 18,55,850 as per AS 19.

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* *Minimum Lease Payment of 4th year includes guaranteed residual value amounting ₹ 1,25,000.*

Illustration 22

Prakash Limited leased a machine to Badal Limited on the following terms:

		(₹ In lakhs)
(i)	*Fair value of the machine*	*48.00*
(ii)	*Lease term*	*5 years*
(iii)	*Lease rental per annum*	*8.00*
(iv)	*Guaranteed residual value*	*1.60*
(v)	*Expected residual value*	*3.00*
(vi)	*Internal rate of return*	*15%*

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively.

Ascertain Unearned Finance Income.

Solution

As per AS 19 on Leases, ***unearned finance income*** is the difference between (a) the ***gross investment*** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Where:

(a) ***Gross investment*** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross investment = Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value (GRV)] + Unguaranteed residual value (URV)

= [(₹ 8,00,000 × 5 years) + ₹ 1,60,000] + ₹ 1,40,000 = ₹ 43,00,000 (a)

(b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	*MLP inclusive of URV ₹*	*Internal rate of return (Discount factor @ 15%)*	*Present Value ₹*
1	8,00,000	0.8696	6,95,680
2	8,00,000	0.7561	6,04,880
3	8,00,000	0.6575	5,26,000
4	8,00,000	0.5718	4,57,440
5	8,00,000	0.4972	3,97,760
	1,60,000 (GRV)	0.4972	79,552

	41,60,000		27,61,312 (i)
	1,40,000 (URV)	0.4972	69,608 (ii)
	43,00,000	(i)+ (ii)	28,30,920(b)

Unearned Finance Income (a) - (b) = ₹ 43,00,000 – ₹ 28,30,920= ₹ 14,69,080.

Disclosures by lessors

As per paragraph 46, the lessor should, in addition to the requirements of AS 10 and the governing statute, make the following disclosures for operating leases:

(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and

  (i) the depreciation recognised in the statement of profit and loss for the period;

  (ii) impairment losses recognised in the statement of profit and loss for the period;

  (iii) impairment losses reversed in the statement of profit and loss for the period;

(b) the future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:

  (i) not later than one year;

  (ii) later than one year and not later than five years;

  (iii) later than five years;

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

(d) accounting policy adopted in respect of initial direct costs.

Note: The Level II and Level III non-corporate entities need not make disclosures required by paragraphs 46(b) and (d).

Sale and Leaseback

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

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

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

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

  If the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately. (Paragraph 52)

  After recognition of loss if any, under paragraph 52, the profit / loss on sale of the asset should be treated in the manner required by paragraph 50. The requirements of paragraph 50 are summarized below:

Case 1: Sale price = Fair Value

Profit or loss should be recognised immediately.

Case 2: Sale Price < Fair Value

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

Case 3: Sale Price > Fair Value

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

Illustration 23

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

(a) Sale price of ₹ 50 lakhs is equal to fair value.

(b) Fair value is ₹ 60 lakhs.

(c) Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.

(d) Fair value is ₹ 40 lakhs and sale price is ₹50 lakhs.

(e) Fair value is ₹ 46 lakhs and sale price is ₹ 50 lakhs

(f) Fair value is ₹ 35 lakhs and sale price is ₹39 lakhs.

Solution

Following will be the treatment in the given cases:

(a) When sales price of ₹ 50 lakhs is equal to fair value, A Ltd. should immediately recognize the profit of ₹10 lakhs (i.e. 50 – 40) in its books.

(b) When fair value is ₹ 60 lakhs then also profit of ₹10 lakhs should be immediately recognized by A Ltd.

(c) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognized by A Ltd. in its books provided loss is not compensated by future lease payment.

(d) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortized over the lease period.

(e) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 - 40) to be immediately recognized in its books and balance profit of ₹4 lakhs (50-46) is to be amortised/deferred over lease period.

(f) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognized by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period.

2.7 AS 20 : Earnings Per Share

This AS came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature.

Applicability

This Statement should be applied by enterprises whose equity shares(ordinary shares) or potential equity shares(potential ordinary shares) are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Standard.

- An *equity share* is a share other than a preference share.
- A *preference share* is a share carrying preferential rights to dividends and repayment of capital.

A *potential equity share* is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

a. Debt instruments or preference shares, that are convertible into equity shares;

b. Share warrants;

c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Objective

The objective of this standard is to prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same reporting periods for the same entity. The focus of this standard is on the denominator of the earnings per share calculation.

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

Note *:This Statement requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).*

Basic Earnings Per Share

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders of the parent entity (the numerator) by the weighted average number of equity shares outstanding (the denominator) during the period.

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS – 5 requires or permits otherwise. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference

dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

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

For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Illustration 24

Date	*Particulars*	*Purchased*	*Sold*	*Balance*
1st January	*Balance at beginning of year*	*1,800*	*-*	*1,800*
31st May	*Issue of shares for cash*	*600*	*-*	*2,400*
1st November	*Buy Back of shares*	*-*	*300*	*2,100*

Calculate Weighted Number of Shares.

Solution

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

The weighted average number of shares can alternatively be computed as follows:

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

List of shares issued	Weight to be considered from
Equity shares issued in exchange for cash	Date of cash receivable
Equity shares issued as a result of the conversion of a debt instrument	Date of conversion
Equity shares issued in lieu of interest or principal on other financial instruments	Date when interest ceases to accrue
Equity shares issued in exchange for the settlement of a liability of the enterprise	Date on which the settlement becomes effective

Equity shares issued as consideration for the acquisition of an asset other than cash	Date on which the acquisition is recognised
Equity shares issued for the rendering of services to the enterprise	When the services are rendered

Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition and in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

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

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

a. A bonus issue;

b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

c. A share split; and

d. A reverse share split (consolidation of shares).

Illustration 25

Date	*Particulars*	*No. of Shares*	*Face Value*	*Paid up Value*
1st January	*Balance at beginning of year*	*1,800*	*₹ 10*	*₹ 10*
31st October	*Issue of Shares*	*600*	*₹ 10*	*₹ 5*

Calculate Weighted Number of Shares.

Solution

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

(1,800 x 12/12) + (300 x 2/12) = 1,850 shares

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources.

The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Illustration 26

Net profit for the year 2011	*₹ 18,00,000*
Net profit for the year 2012	*₹ 60,00,000*
No. of equity shares outstanding until 30th September 2012	*20,00,000*

Bonus issue 1st October 2012 was 2 equity shares for each equity share outstanding at 30th September, 2012

Calculate Basic Earnings Per Share.

Solution

No. of Bonus Issue 20,00,000 × 2 = 40,00,000 shares

Earnings per share for the year 2012 $= \frac{60,00,000}{(20,00,000 + 40,00,000)}$ = ₹ 1.00

Adjusted earnings per share for the year 2011 $= \frac{18,00,000}{(20,00,000 + 40,00,000)}$ = ₹ 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 2011, the earliest period reported.

In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

Fair value per share immediately prior to the exercise of rights

Theoretical ex-rights fair value per share

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

Illustration 27

Net profit for the year 2011	*₹ 11,00,000*
Net profit for the year 2012	*₹ 15,00,000*
No. of shares outstanding prior to rights issue	*5,00,000 shares*
Rights issue price	*₹ 15.00*
Last date to exercise rights	*1st March 2012*

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)

Fair value of one equity share immediately prior to exercise of rights on 1st March 2012 was ₹ 21.00. Compute Basic Earnings Per Share.

Solution

Fair value of shares immediately prior to exercise of rights + Total amount received from exercise. Number of shares outstanding prior to exercise + number of shares issued in the exercise

$$\frac{(₹\ 21.00 \times 5,00,000 \text{ shares}) + (₹\ 15.00 \times 1,00,000 \text{ shares})}{5,00,000 \text{ shares} + 1,00,000 \text{ shares}}$$

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

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

$$\frac{₹(21.00)}{₹(20.00)} = 1.05$$

Computation of earnings per share:

EPS for the year 2011 as originally reported: ₹ 11,00,000/5,00,000 shares = ₹ 2.20

EPS for the year 2011 restated for rights issue: ₹ 11,00,000/ (5,00,000 shares x 1.05) = ₹ 2.10

EPS for the year 2012 including effects of rights issue:

(5,00,000 x 1.05 x 2/12) + (6,00,000 x 10/12) = 5,87,500 shares

EPS = 15,00,000/5,87,500 = ₹ 2.55

Diluted Earnings Per Share

In calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity shareholders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions

Effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

a. The net profit for the period attributable to equity shares is:

   i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

   ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

   iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

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

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting

period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

In order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Illustration 28

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

Compute Diluted Earnings Per Share.

Solution

Adjusted net profit for the current year (1,00,00,000 + 12,00,000 – 3,60,000) = ₹ 1,08,40,000

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS: (50,00,000 + 10,00,000) = 60,00,000 Shares

Diluted earnings per share: (1,08,40,000/60,00,000) = ₹ 1.81

Restatement

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

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

Disclosure

An enterprise should disclose the following:

a. The amounts used as the *numerators* in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

b. The *weighted average number of equity shares* used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

c. The *nominal value of shares* along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

Illustration 29

Net profit for the year 2012	₹ 12,00,000
Weighted average number of equity shares outstanding during the year 2012	5,00,000 shares
Average fair value of one equity share during the year 2012	₹ 20.00
Weighted average number of shares under option during the year 2012	1,00,000 shares
Exercise price for shares under option during the year 2012	₹ 15.00

Compute Basic and Diluted Earnings Per Share.

Solution

Computation of earnings per share

	Earnings ₹	Shares	Earnings/ Share ₹
Net profit for the year 2012	12,00,000		

Weighted average no. of shares during year 2012		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (100,000 x 15.00)/20.00		(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

2.8 AS 26 : Intangible Assets

AS 26, came into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

i. Enterprises whose equity or debt securities are listed on a recognized stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the board of directors' resolution in this regard.

ii. All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

In respect of all other enterprises, the Accounting Standard came into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

Scope

This Statement should be applied by all enterprises in accounting for intangible assets, except:

a. Intangible assets that are covered by another Accounting Standard like AS 2; 7; 14; 19; 21 & 22.

b. Financial assets.

c. Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and

d. Intangible assets arising in insurance enterprises from contracts with policyholders.

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

This Statement also applies to:

(i) expenditure on advertising, training, start - up cost

(ii) Research and development activities

(iii) Right under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts

(iv) Patents, copyrights and trademarks

(v) goodwill

An asset is a resource:

a. Controlled by an enterprise as a result of past events and

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

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

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

An active market is a market where all the following conditions exist:

a. The items traded within the market are homogeneous.

b. Willing buyers and sellers can normally be found at any time and

c. Prices are available to the public.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

A financial asset is any asset that is:

a. Cash,

b. A contractual right to receive cash or another financial asset from another enterprise,

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable or

d. An ownership interest in another enterprise.

Intangible Assets

An intangible asset is

- an identifiable
- non-monetary asset
- without physical substance

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

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks.

Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. If use of physical assets is possible only with the intangible part of it, we treat them as Fixed Assets like Operating system for computers. If physical element is just to support intangible part of it, we treat them as intangible assets.

Identifiability

- The definition of an intangible asset requires that an intangible asset be *identifiable*. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill.
- An intangible asset can be clearly distinguished from goodwill if the asset is *separable*. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.
- Though Separability is not a necessary condition for identifiability. If an asset generates *future economic benefits* only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality.

Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise. As employees may quite the concern anytime or even loyal customers may decide to purchase goods and services from other suppliers. Moreover these items don't even qualify as intangible asset as per the definition given in this AS.

Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise.

Recognition and Initial Measurement of an Intangible Asset

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

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 intangible asset should be measured initially at cost.

An enterprise should assess the probability of futue 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

Separate Acquisition

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

Acquisition as part of an Amalgamation

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14. In accordance with this Statement:

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

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

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of

separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Internally Generated Intangible Assets

Internally generated goodwill should not be recognised as an asset.

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

- Research Phase &
- Development Phase

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

Research Phase

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

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

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

b. The search for, evaluation and final selection of, applications of research findings or other knowledge.

c. The search for alternatives for materials, devices, products, processes, systems or services;

d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

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

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

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

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

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

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

Examples of development activities are:

a. The design, construction and testing of pre-production or pre-use prototypes and models.

b. The design of tools, jigs, moulds and dies involving new technology.

c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and

d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

An enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets.

This Statement takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes, if applicable:

a Expenditure on materials and services used or consumed in generating the intangible asset.

b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.

c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licenses that are used to generate the asset and

d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

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

a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.

b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and

c. Expenditure on training the staff to operate the asset.

Recognition of an Expense

Expenditure on an intangible item should be recognised as an expense when it is incurred

unless:

a. It forms part of the cost of an intangible asset that meets the recognition criteria or

b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

It does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Expenses recognized as expenses cannot be reclassified as cost of Intangible Asset in later years.

Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and

b. The expenditure can be measured and attributed to the asset reliably.

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

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

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

Amortisation Period

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

Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

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

a. Amortises the intangible asset over the best estimate of its useful life.

b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and

c. Discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain.There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

Amortisation Method

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include *the straight-line method, the diminishing balance method and the unit of production method*. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

Residual Value

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

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

a. There is a commitment by a third party to purchase the asset at the end of its useful life or

b. There is an active market for the asset and:

   i. Residual value can be determined by reference to that market and

   ii. It is probable that such a market will exist at the end of the asset's useful life.

Recoverability of the Carrying Amount-Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28. AS 28 “Impairment

of Assets" is not covered under IPCC curriculum and will be discussed in the Final level of CA course.

If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under AS 28 and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

In addition to the requirements of AS 28, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

a. An intangible asset that is not yet available for use and

b. An intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under AS 28 and impairment losses recognised accordingly.

If the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the required impairment test and makes the disclosure required.

Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) if

- disposed or
- when no future economic benefits are expected from its use.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Disclosure

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

1. The useful lives or the amortisation rates used.

2. The amortisation methods used.
3. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
4. A reconciliation of the carrying amount at the beginning and end of the period showing:
   I. Additions, indicating separately those from internal development and through amalgamation.
   II. Retirements and disposals.
   III. Impairment losses recognised in the statement of profit and loss during the period.
   IV Impairment losses reversed in the statement of profit and loss during the period.
   V Amortisation recognised during the period and
   VI Other changes in the carrying amount during the period.

Other Disclosures

The financial statements should also disclose:

a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.
b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.
c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and
d. The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

Transitional Provisions

Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under this Statement and the period determined has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined has not expired on the date of this Statement coming into effect and:

a. If the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

b. If the remaining period as per the accounting policy followed by the enterprise:

   i. Is shorter as compared to the balance of the period determined, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

   ii. Is longer as compared to the balance of the period determined, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

Illustration 30

ABC Ltd. developed know-how by incurring expenditure of ₹ 20 lakhs, The know-how was used by the company from 1.4.2005. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.2012. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.2012.

Solution

Journal Entry

		₹	₹
Profit and Loss A/c (Prior period item)	Dr.	12,00,000	
Depreciation A/c	Dr.	2,00,000	
To Know-how A/c*			14,00,000
[Being depreciation of 7 years (out of which depreciation of 6 years charged as prior period item)]			

* As per para 63 of AS 26 "Intangible Assets", 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. Amortisation should commence when the asset is available for use.

Illustration 31

The company had spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 2011-2012, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2012.

Answer

In the given case, the company spent ₹ 45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/benefit because of the failure of the product. Thus according to paras 41 to 43 of AS 26 'Intangible Assets', the company should charge the total amount of ₹ 45 lakhs as an expense in the profit and loss account.

Illustration 32

A company with a turnover of ₹ 250 crores and an annual advertising budget of ₹ 2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of ₹ 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of ₹ 2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct?

Answer

According to paras 55 and 56 of AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset". In the given case, advertisement expenditure of ₹ 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of ₹ 25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹ 2 crores to the Profit and Loss account of the year is correct.

Illustration 33

Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at ₹ 10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be ₹ 36,00,000, ₹ 46,00,000, ₹ 44,00,000, ₹ 40,00,000 and ₹ 34,00,000. Find out the amortization cost of the patent for each of the years.

Solution

Swift Limited amortised ₹ 10,00,000 per annum for the first two years i.e. ₹ 20,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

Year	*Net cash flows ₹*	*Amortization Ratio*	*Amortization Amount ₹*
I	-	0.125	10,00,000[2]
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000
VII	34,00,000	0.170	10,20,000
Total	2,00,00,000	1.000	80,00,000

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 60,00,000 has been amortized in the ratio of net cash flows arising from the product of Swift Ltd.

Note*:* The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years.

2.9 AS 29 : Provisions, Contingent Liabilities and Contingent Assets

This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

i. Those resulting from financial instruments that are carried at fair value;

ii. Those resulting from executory contracts;

iii. Those arising in insurance enterprises from contracts with policy-holders; and

iv. Those covered by another Accounting Standard.

Where any other Accounting Standard like AS 7; AS 9; AS 15, and AS 19 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement.

[2] It has been assumed that the company had amortized the patent at ₹ 10,00,000 per annum in the first two years on the basis of economic benefits derived from the product manufactured under the patent.

Definitions

- ***Executory contracts*** are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.
- **A *Provision*** is a liability which can be measured only by using a substantial degree of estimation.
- **A *Liability*** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- **An *Obligating event*** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.
- **A *Contingent liability*** is:

  (a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

  (b) A present obligation that arises from past events but is not recognised because:

    (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

    (ii) A reliable estimate of the amount of the obligation cannot be made.
- **A *Contingent asset*** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
- ***Present obligation*** - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.
- ***Possible obligation*** - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

Present Obligation

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence. On the basis of such evidence:

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

(b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability.

Past Event

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

Main features are:

- The liabilities to be recognised in an enterprise's balance sheet are those that exist at the balance sheet date.
- It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. *Examples:* Penalties or clean up costs for unlawful environmental damage.
- An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.
- Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

Probable Outflow of Resources Embodying Economic Benefits

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

Reliable Estimate of the Obligation

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

Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed.

A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of

future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs.

Recognition:

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The balance is recognized as a provision, except where no reliable estimate can be made.

Contingent Assets

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

Recognition:

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

However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority.

Measurement

Best Estimate

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The amount of a provision should not be discounted to its present value ***except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.*** The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22.

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

Future Events

Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

Expected Disposal of Assets

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

Reimbursements

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

Changes in Provisions

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

Use of Provisions

Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

Future Operating Losses

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

Restructuring

A restructuring is a programme that is planned and controlled by management and materially changes either:

i. The scope of a business undertaken be an enterprise; or

ii. The manner in which that business is conducted.

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

(a) Sale or termination of a line of business;

(b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) Changes in management structure, for example, eliminating a layer of management; and

(d) Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the recognition criteria for provisions. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) Necessarily entailed by the restructuring; and

(b) Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

(a) Retraining or relocating continuing staff;

(b) Marketing; or

(c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for

restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

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

As required by paragraph 44 of the satndard, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

1. For each class of provision, an enterprise should disclose:
   - The carrying amount at the beginning and end of the period;
   - Additional provisions made in the period, including increases to existing provisions;
   - Amounts used (i.e. incurred and charged against the provision) during the period; and
   - Unused amounts reversed during the period.
2. An enterprise should disclose the following for each class of provision:
   - A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
   - An indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, and
   - The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.
3. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
   - An estimate of its financial effect,
   - An indication of the uncertainties relating to any outflow; and
   - The possibility of any reimbursement.
4. Where any information required for contingent liability is not disclosed because it is not practicable to do so, the fact should be stated properly.

Transitional Provisions

As per the amendment made in AS 29 in the year, 2016 all the existing provisions for decommissioning, restoration and similar liabilities should be discounted prospectively, with the corresponding effect to the related item of property, plant and equipment.

Illustration 34

EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2014. The company seeks your advice on the following:

(i) The Company's sales tax assessment for assessment year 2011-12 has been completed on 14th February, 2014 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

(ii) The Company has entered into a wage agreement in May, 2014 whereby the labour union has accepted a revision in wage from June, 2013. The agreement provided that the hike till May, 2014 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2014.

Answer

(i) Since the company is not appealing against the addition of ₹ 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 2014. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed along with the contingent liability of ₹ 2.10 crore.

(ii) The arrears for the period from June, 2013 to March, 2014 are required to be provided for in the accounts of the company for the year ended on 31st March, 2014.

Miscellaneous Illustrations

Illustration 35

How would you deal with the following in the annual accounts of a company for the year ended 31st March, 2013?

(a) The company has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the Suppliers' Godown. Up to 2011-12, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2011-12. This would result into decrease in profit by ₹ 7.60 lakhs

(b) Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 2005 to September, 2011 has been received and paid in February, 2012.

Solution

(a) Para 29 of AS 5 (Revised) 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" states that a change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise. Therefore the change in the method of stock valuation is justified in view of the fact that the change is in line with the recommendations of AS 2 (Revised) 'Valuation of Inventories' and would result in more appropriate preparation of the financial statements. As per AS 2, this accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in the financial statements.

Also, appropriate disclosure of the change and the amount by which any item in the financial statements is affected by such change is necessary as per AS 1, AS 2 and AS 5. Therefore, the under mentioned note should be given in the annual accounts.

"In compliance with the Accounting Standards issued by the ICAI, delayed cotton clearing charges which are in the nature of interest have been excluded from the valuation of closing stock unlike preceding years. Had the company continued the accounting practice followed earlier, the value of closing stock as well as profit before tax for the year would have been higher by ₹ 7.60 lakhs."

(b) The final bill having been paid in February, 2012 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2012. However it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2012, this material charge has arisen in the current period i.e., year ended 31st March, 2013. Therefore it should be treated as 'Prior period item' as per para 16 of AS 5. As per para 19 of AS 5 (Revised), prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per Para 10 of AS 5 (Revised). For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity

board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.'

Illustration 36

In preparing the financial statements of R Ltd. for the year ended 31st March, 2013, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2013 in the acquisition of another company doing similar business, the negotiations for which had started during the financial year.

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2013 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Para 3.2 of AS 4 (Revised) defines "Events occurring after the balance sheet date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the 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 para 15 which clearly states 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 ₹ 100 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.

Illustration 37

A Limited Company closed its accounting year on 30.6.13 and the accounts for that period were considered and approved by the board of directors on 20th August, 2013. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2013 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.13.

Solution

Para 3.2 of AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which

financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above mentioned definition and requirements given in paras 13-15 of the said AS 4 (Revised).

In this case the incidence, which was expected to push up cost became evident after the date of approval of the accounts. So that was not an 'event occurring after the balance sheet date'. However, this may be mentioned in the Directors' Report.

Illustration 38

While preparing its final accounts for the year ended 31st March, 2013 a company made a provision for bad debts @ 5% of its total debtors. In the last week of February, 2013 a debtor for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2013 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, 2013?

Solution

As per paras 8.2 and 13 of Accounting Standard 4 on 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 estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 2013. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 2013, then mere disclosure required as per para 15, would have been sufficient.

Illustration 39

At the end of the financial year ending on 31st December, 2013, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	*Loss (₹)*
In respect of five cases (Win)	*100%*	*–*
Next ten cases (Win)	*60%*	*–*
Lose (Low damages)	*30%*	*1,20,000*
Lose (High damages)	*10%*	*2,00,000*
Remaining five cases		

Win	*50%*	*–*
Lose (Low damages)	*30%*	*1,00,000*
Lose (High damages)	*20%*	*2,10,000*

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

Solution

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 of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of ₹ 1,20,000 + 10% of ₹ 2,00,000

= ₹ 36,000 + ₹ 20,000 = ₹ 56,000

Expected loss in remaining five cases = 30% of ₹ 1,00,000 + 20% of ₹ 2,10,000

= ₹ 30,000 + ₹ 42,000 = ₹ 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 9,20,000 (₹ 56,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Illustration 40

X Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

(Accounting year 1.1.2012 – 31.12.2012)

Net Profit	:	*Year 2012 : ₹ 20,00,000*
	:	*Year 2013 : ₹ 30,00,000*
No. of shares outstanding prior to Right Issue	:	*10,00,000 shares*
Right Issue	:	*One new share for each four Out standing i.e., 2,50,000 shares.*
		Right Issue price – ₹ 20
		Last date of exercise rights – 31.3.2013.
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2013	:	*₹ 25*

Solution

Computation of Basic Earnings Per Share
(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 2010 ₹	Year 2011 ₹
EPS for the year 2012 as originally reported = $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$		
= (₹ 20,00,000 / 10,00,000 shares)	2.00	
EPS for the year 2012 restated for rights issue = [₹ 20,00,000 / (10,00,000 shares × 1.04*)]	1.92 (approx.)	
EPS for the year 2013 including effects of rights issue $\frac{₹\ 30,00,000}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$		
$\frac{₹\ 30,00,000}{11,97,500 \text{ shares}}$		2.51 (approx.)

Working Notes:

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

* Refer working note 2.

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

$$= \frac{(₹\ 25 \times 10,00,000 \text{ shares}) + (₹\ 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}} = \frac{₹\ 3,00,00,000}{12,50,000 \text{ shares}} = ₹\ 24$$

2. *Computation of adjustment factor*

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}} = \frac{₹\ 25}{₹\ 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$