

Accounting Standards and Guidance Notes

UNIT 1: INTRODUCTION TO ACCOUNTING STANDARDS

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, treatment, presentation and disclosure of accounting transactions in the financial statements.

1.1 Objectives of Accounting Standards

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true state of affairs. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards provide framework and standard accounting policies so that the financial statements of different enterprises become comparable.

The Accounting Standards reduce the accounting alternatives in the preparation of rational financial statements thereby ensuring comparability of financial statements of different enterprises. The Accounting Standards deal with the issues of

- (i) recognition of events and transactions in the financial statements,
- (ii) measurement of these transactions and events,
- (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and
- (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into these financial statements which helps the users to take prudent and informed business decisions.

The objective of Accounting Standards is to standardize diverse accounting policies with a view to eliminate, to the maximum possible extent,

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

1.2 Financial Reporting

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The concept of Accounting Standards and the standards setting process in India has already been discussed, in detail, in Intermediate (IPC) Paper 1: Accounting Study Material – Chapter 1.

1.2 Benefits and Limitations

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

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

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

- (i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- (ii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

1.3 Standard-Setting Process

The need for accounting standards specifically suitable for the country's economic environment was also felt in India. Recognising the need to harmonise the diverse accounting policies and practices in India and keeping in view the international developments in the field of accounting, the Council of the Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) on 21st April, 1977. The composition of ASB is broad based to ensure

due representation and the participation of all those who are interested in the formulation and implementation of these standards. Apart from the elected members of the Council of the ICAI nominated on the ASB, there are various Central Government nominees, nominees from various other professional institutes like the Institute of Cost Accountants of India, Institute of Company Secretaries of India, Representatives of Industry Associations, Reserve Bank of India, Securities and Exchange Board of India, Controller General of Accounts, Central Board of Excise and Customs, Representative of Academic and Financial Institutions, other eminent professionals co-opted by the ICAI and any representative(s) of other body, as considered appropriate by the ICAI.

The preliminary drafts of the standards are prepared by the Study Groups which take up specific subjects assigned to them. The draft so prepared is considered by ASB and sent to various outside bodies like FICCI, ASSOCHAM, SCOPE, CLB, C & AG, ICAI (earlier ICWAI), ICSI, CBDT etc. After taking into consideration their views, the draft of the standards is issued as an Exposure Draft (ED) for comments by members of ICAI and the public at large. The comments on the ED are considered by ASB and a final draft of the standard is submitted to the Council of the ICAI for its approval and is thereafter issued as a definitive standard.

1.4 How Many Accounting Standards?

The council of the Institute of Chartered Accountants of India has, so far, issued *thirty-two Accounting Standards*. However, *AS 6 on 'Depreciation Accounting' has been withdrawn on revision of AS 10 'Property, Plant and Equipment'* and AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are **30** Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.5 Status of Accounting Standards

It has already been mentioned that the standards are developed by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India and are issued under the authority of its Council. The institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. The accounting standards are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exception as stated below. The implication of mandatory status of an accounting standard depends on whether the statute governing the enterprise concerned requires compliance with the standard. The Companies Act had earlier notified 28 accounting standards and mandated the corporate entities to comply with the provisions stated therein. *However, in 2016 the MCA has*

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

1.4 Financial Reporting

withdrawn AS 6. Hence, effectively there are now only 27 notified accounting standards as per the Companies (Accounting Standards) Rules, 2006 (as amended in 2016).

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

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

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

1.6 Applicability of Accounting Standards

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

However, when the accounting standards were notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards*, the Central Government also issued the 'Criteria for Classification of Entities and Applicability of Accounting Standards' for the companies.

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

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

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

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

largely aligned with the criteria prescribed for corporate entities, it was decided to continue with the three levels of entities for non-corporate entities vis-à-vis two levels prescribed for corporate entities as per the government notification.

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

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

Level I Entities

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

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

Level II Entities (SMEs)

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

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

Level III Entities (SMEs)

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

*This change is made as per the announcement 'Revision in the criteria for classifying Level II non-corporate entities'. This revision is applicable with effect from the accounting year commencing on or after April 01, 2012.

1.6 Financial Reporting

Additional requirements

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

Illustration 1

M/s Omega & Co. (a partnership firm), had a turnover of ₹ 1.25 crores (excluding other income) and borrowings of ₹ 0.95 crores in the previous year. It wants to avail the exemptions available in application of Accounting Standards to non-corporate entities for the year ended 31.3.2016. Advise the management

of M/s Omega & Co in respect of the exemptions of provisions of ASs, as per the directive issued by the ICAI.

Solution

The question deals with the issue of Applicability of Accounting Standards to a non-corporate entity. For availment of the exemptions, first of all, it has to be seen that M/s Omega & Co. falls in which level of the non-corporate entities. Its classification will be done on the basis of the classification of non-corporate entities as prescribed by the ICAI. According to the ICAI, non-corporate entities can be classified under 3 levels viz Level I, Level II (SMEs) and Level III (SMEs).

An entity whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year, will fall under the category of Level I entities. Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

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

As the turnover of M/s Omega & Co. is more than ₹ 1 crore, it falls under 1st criteria of Level II non-corporate entities as defined above. Even if its borrowings of ₹ 0.95 crores is less than ₹ 1 crores, it will be classified as Level II Entity. In this case, AS 3, AS 17, AS 21, AS 23, AS 27 will not be applicable to M/s Omega & Co. Relaxations from certain requirements in respect of AS 15, AS 19, AS 20, AS 25, AS 28 and AS 29 are also available to M/s Omega & Co.

1.6.2 Criteria for classification of Companies under the Companies (Accounting Standards) Rules, 2006

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

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

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

1.8 Financial Reporting

- (v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause 2(f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

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

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:

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

"The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

- 1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

- 1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

- 1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

- 1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

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

B Other Instructions

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

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

1.6.3 Applicability of Accounting Standards to Companies

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

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	<i>Property, Plant and Equipment**</i>
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 22	Accounting for Taxes on Income
AS 24	Discontinuing Operations
AS 26	Intangible Assets

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

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

1.10 Financial Reporting

1.6.3.2 Exemptions or Relaxations for SMCs as defined in the Notification

- (A) *Accounting Standards not applicable to SMCs in their entirety:*
- AS 3 Cash Flow Statements
 - AS 17 Segment Reporting
- (B) *Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs*:*
- (i) AS 21, Consolidated Financial Statements
 - (ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
 - (iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)
- (C) *Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:*
- (i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)
 - (a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);
 - (b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;
 - (c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and
 - (d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined

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

by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

- (ii) AS 19, Leases
Paragraphs 22 (c), (e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.
- (iii) AS 20, Earnings Per Share
Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.
- (iv) AS 28, Impairment of Assets
SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.
- (v) AS 29, Provisions, Contingent Liabilities and Contingent Assets
Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.
- (D) *AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.*

1.6.4 Applicability of Accounting Standards to Non-corporate Entities

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

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition

1.12 Financial Reporting

AS 10	<i>Property, Plant and Equipment**</i>
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 22	Accounting for Taxes on Income
AS 26	Intangible Assets

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

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

AS 3	Cash Flow Statements
AS 17	Segment Reporting

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

AS 3	Cash Flow Statements
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 24	Discontinuing Operations

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

(i)	AS 21, Consolidated Financial Statements
(ii)	AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

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

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

(iii)	AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)
-------	---

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

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

- (1) Level II and Level III Non-corporate entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:
 - (a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);
 - (b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;
 - (c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and
 - (d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.
- (2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:
 - (a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

1.14 Financial Reporting

- (b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;
- (c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and
- (d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) AS 19, Leases

Paragraphs 22 (c), (e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to non-corporate entities falling in Level II. Paragraphs 22 (c), (e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III entities.

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to non-corporate entities falling in Level II and Level III.

- (E) *AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non-corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results e.g.,*

quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

1.7 List of Accounting Standards

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

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

1.16 Financial Reporting

22	Accounting for Taxes on Income	01/04/2006
23	Accounting for Investments in Associates in Consolidated Financial Statements	01/04/2002
24	Discontinuing Operations	01/04/2004
25	Interim Financial Reporting	01/04/2002
26	Intangible Assets	01/04/2003
27	Financial Reporting of Interests in Joint Ventures	01/04/2002
28	Impairment of Assets	01/04/2008
29	Provisions, Contingent Liabilities and Contingent Assets	01/04/2004
30*	Financial Instruments: Recognition and Measurement	01/04/2009 (Encourage to follow**)
31*	Financial Instruments: Presentation	01/04/2009 (Encourage to follow**)
32*	Financial Instruments: Disclosures	01/04/2009 (Encourage to follow**)

AS 1 to AS 29 (excluding **AS 6 and AS 8**) have been discussed in detail in the succeeding units of this chapter. AS 30, 31 and 32 are not applicable from the examination point of view hence not discussed in detail.

1.8 Development in the area of Accounting Standards in India

1.8.1 Need for Convergence towards Global Standards

In the present era of globalisation and liberalisation, the world has become an economic village. The globalisation of the business world and the attendant structures and the regulations, which support it, as well as the development of e-commerce make it imperative to have a single globally accepted financial reporting system. A number of multi-national companies are establishing their businesses in various countries with emerging economies and *vice versa*. The entities in emerging economies are increasingly accessing the global markets to fulfill their capital needs by getting their securities listed on the stock exchanges outside their country. Capital markets are, thus, becoming integrated consistent with this world-wide trend. More and more Indian companies are being listed on overseas stock exchanges. The use of different

*AS 30, 31 and 32 are not applicable from the examination point of view. However, the same have been mentioned above for knowledge purpose only.

**The status of AS 30, 31 and 32 is "Encourage to Follow" for non-corporate entities. For corporate entities these standards are not notified, hence not applicable. For them Ind AS will be made applicable in a phase manner.

accounting frameworks in different countries, which require inconsistent treatment and presentation of the same underlying economic transactions, creates confusion for users of financial statements. This confusion leads to inefficiency in capital markets across the world. Therefore, increasing complexity of business transactions and globalisation of capital markets call for a single set of high quality accounting standards.

High standards of financial reporting underpin the trust investors place in financial and non-financial information. Thus, the case for a single set of globally accepted accounting standards has prompted many countries to pursue convergence of national accounting standards with IFRSs.

International Financial Reporting Standards (IFRSs) are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities requires public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So over the next few years, thousands of companies will adopt the international

1.8.2 Benefits of Convergence with IFRSs

There are many beneficiaries of convergence with IFRSs such as the economy, investors, industry etc.

The Economy: When the markets expand globally the need for convergence increases since the convergence benefits the economy by increasing growth of its international business. It facilitates maintenance of orderly and efficient capital markets and also helps to increase the capital formation and thereby economic growth. It encourages international investing and thereby leads to more foreign capital flows to the country.

Investors: A strong case for convergence can be made from the viewpoint of the investors who wish to invest outside their own country. Investors want the information that is more relevant, reliable, timely and comparable across the jurisdictions. Financial statements prepared using a common set of accounting standards help investors better understand investment opportunities as opposed to financial statements prepared using a different set of national accounting standards. Investors' confidence is strong when accounting standards used are globally accepted. Convergence with IFRSs contributes to investors' understanding and confidence in high quality financial statements.

The Industry: A major force in the movement towards convergence has been the interest of the industry. The industry is able to raise capital from foreign markets at lower cost if it can create confidence in the minds of foreign investors that their financial statements comply with globally accepted accounting standards. With the diversity in accounting standards from country to country, enterprises which operate in different countries face a multitude of accounting requirements prevailing in the countries. The burden of financial reporting is lessened with convergence of accounting standards because it simplifies the process of preparing the individual and group financial statements and thereby reduces the costs of preparing the financial statements using different sets of accounting standards.

1.9 Convergence Strategy

In the scenario of globalisation, India cannot insulate itself from the developments taking place worldwide. In India, so far as the ICAI and the Government authorities such as the National Advisory Committee on Accounting Standards established under the Companies Act, 1956, and various regulators such as Securities and Exchange Board of India and Reserve Bank of India are concerned, the aim has always been to comply with the IFRSs to the extent possible with the objective to formulate sound financial reporting standards. The ICAI, being a member of the International Federation of Accountants (IFAC), considered the IFRSs and tried to integrate them, to the extent possible, in the light of the laws, customs, practices and business environment prevailing in India.

UNIT 2 : AS 1 : DISCLOSURE OF ACCOUNTING POLICIES

2.1 Introduction

Irrespective of extent of standardisation, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard. Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time. The accounting standards therefore permit more than one accounting policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

During 1977, when ASB was established, the business environment in India was such that enterprises were reluctant to prepare accounting notes, few enterprises used to disclose the important accounting policies but the degree and method of disclosure varies considerably. Some enterprises used to disclose them as part of main financial statement, few others as a supplementary.

Therefore the main aim of this statement is not only to promote disclosure of accounting policies but also to determine that all accounting policies are disclosed at one place as main part of the financial statement.

AS 1 deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements. The purpose of the Standard is to promote better understanding of financial statements by establishing through an Accounting Standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

2.2 Applicability

This AS was issued in 1979 and is now mandatory and applicable for all enterprises.

2.3 Fundamental Accounting Assumptions

The Accounting Standard 1 recognises three fundamental accounting assumptions. These are:

- (a) Going Concern

1.20 Financial Reporting

- (b) Consistency and
- (c) Accrual.

So long as these assumptions are followed in preparation of financial statements, no disclosure of such adherence is necessary. Any departure from any of these assumptions should however be disclosed.

(a) Going Concern Assumption: The enterprise is normally viewed as a going concern, i.e. as continuing operations for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or curtailing, materially its scale of operations.

Accordingly, assets and liabilities are recorded on the basis that the enterprise will be able to realise its assets and discharge its liabilities in the normal course of business. If an enterprise is not a going concern, valuation of its assets and liabilities on historical cost becomes irrelevant and as a consequence its profit/loss may not give reliable information.

Example: A Ltd. has proposed to acquire B Ltd. in January, 2017. The acquisition of B Ltd. took place during May 2017, since then B Ltd. is no more a going concern. This fact should be disclosed in the financial statements of B Ltd. for the year ended March 31, 2017.

(b) Accrual Assumption: Revenues and costs are recorded as they are accrued, i.e., revenue items are recognized as they are earned or incurred and recorded in the financial statements of the periods to which they relate even though payment and receipt of actual cash has not been taken place. This assumption is the core of accrual accounting system.

Example: Credit sales of goods on March 01, 2017; money receivable after three months are recognised as sales during the financial year 2016-17 itself and amount due is debited to the customer's account. Similarly, credit purchase of goods is also recorded as purchases during the year when purchase takes place and amount payable is credited to the suppliers account in the year of purchase though the payment is made in the next financial year.

(c) Consistency Assumption: It is assumed that accounting policies are consistent from one period to another. Unless this is done, comparatives are rendered meaningless. If comparability is lost, the relevance of accounting data for users' judgment and decision-making is gone.

Example: If enterprise has opted for written down value method of charging depreciation then in the following years, it should stick to this method only, unless under changed environment it is considered highly inappropriate to continue with it.

2.4 Disclosure of Deviations from Fundamental Accounting Assumptions

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

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy.

2.5 Accounting Policies

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

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

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

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

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

Since accounting policy adopted will have considerable effect on the financial results disclosed by the financial statement, it makes it almost difficult to compare two financial statements.

2.6 Considerations in the Selection of Accounting Policies

The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a **true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.** To ensure the true and fair consideration this statement issues following guidelines:

Prudence: As defined in the statement, prudence means recognising all losses immediately but ignoring anticipated profits. Business environment is highly dynamic, therefore, enterprises has to keep anticipate the future and take managerial decisions accordingly. In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

1.22 Financial Reporting

Example: If valuation of inventory is always done at cost, consider a situation where market price of the relevant goods has reduced below the cost price, then valuing inventory at cost price means ignoring anticipated losses. Similarly if inventory is always valued at market price, then take a situation where cost price is below market price, indirectly we are recognising the anticipated gross profit on inventory in the books. Therefore, accounting policy should be cost price or market price whichever is less, in this case we are ignoring anticipated profits (if any) but any anticipated losses would be taken care of.

Substance over form: The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

Example: The ownership of an asset purchased on hire purchase is not transferred till the payment of the last instalment is made but the asset is shown in the books of the hire purchaser. Similarly, in the case of the amalgamation, the entry for amalgamation in the books of the amalgamated company is recorded on the basis of the status of the shareholders of amalgamating company after amalgamation i.e. if all or almost all the shareholders of the amalgamated company has become shareholder of the amalgamating company by virtue of amalgamation, we record all the transactions as Amalgamation in nature of Merger otherwise it is recorded as Amalgamation in nature of Purchase.

Materiality: Financial statements should disclose all 'material' items, ie items the knowledge of which might influence the decisions of the user of the financial statements.

The materiality of an item is decided on the basis that whether non-disclosure of the item will effect the decision making of the user of accounts. If the answer is positive then the item is material and should be disclosed, in case answer is negative, item is immaterial. This statement does not mean that immaterial item should not be disclosed, disclosure or non-disclosure of an immaterial item is left at the discretion of the accountant but disclosure of material item is been made mandatory.

Example: Any penalty paid by the enterprise should be disclosed separately even though the amount paid is negligible, payment of any tax also should be disclosed separately and not to be merged with office expenses or miscellaneous expense.

2.7 Disclosure of Accounting Policies

- (i) To ensure proper understanding of financial statements, it is necessary that **all significant accounting policies adopted** in the preparation and presentation of financial statements **should be disclosed**.
- (ii) The **disclosure of the significant accounting policies** as such should **form part of the financial statements** and the significant accounting policies should normally be **disclosed at one place**.

2.8 Disclosure of Changes in Accounting Policies

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

2.9 Illustrations

Illustration 1

ABC Ltd. was making provision for non-moving inventories based on no issues for the last 12 months up to 31.3.2016.

The company wants to provide during the year ending 31.3.2017 based on technical evaluation:

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

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

Solution

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

In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2016-17:

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

Illustration 2

Jagannath Ltd. had made a rights issue of shares in 2015. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2017. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:

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

1.24 Financial Reporting

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

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2016-2017.

Solution

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

Notes on Accounts:

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

Illustration 3

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

Solution

Para 17 of AS-1 'Disclosure of Accounting Policies' recognises 'prudence' as one of the major considerations governing the selection and application of accounting policies. In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Also as per para 10 of the AS 1, 'accrual' is one of the fundamental accounting assumptions. Irrespective of the terms of the contract, so long as the principal amount of a loan is not repaid, the lender cannot be replaced in a disadvantageous position for non-payment of interest in respect of overdue amount. From the aforesaid, it is apparent that the company has an obligation on account of the overdue interest. In this situation, the company should provide for the liability (since it is not waived by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case. However, in respect of the overdue interest amounts, which are settled, the liability should be accrued to the extent of amounts settled. Non-provision of the overdue interest liability amounts to violation of accrual basis of accounting. Therefore, the treatment, done by the company, of not providing the interest amount from due date to the date of repayment is not correct.

Reference: The students are advised to refer the full text of AS 1 "Disclosure of Accounting Policies".

UNIT 3 : AS 2 : VALUATION OF INVENTORIES

3.1 Introduction

The accounting treatment for inventories is prescribed in AS 2 'Valuation of Inventories', which provides guidance for determining the value at which inventories, are carried in the financial statements until related revenues are recognised. It also provides guidance on the cost formulas that are used to assign costs to inventories and any write-down thereof to net realisable value.

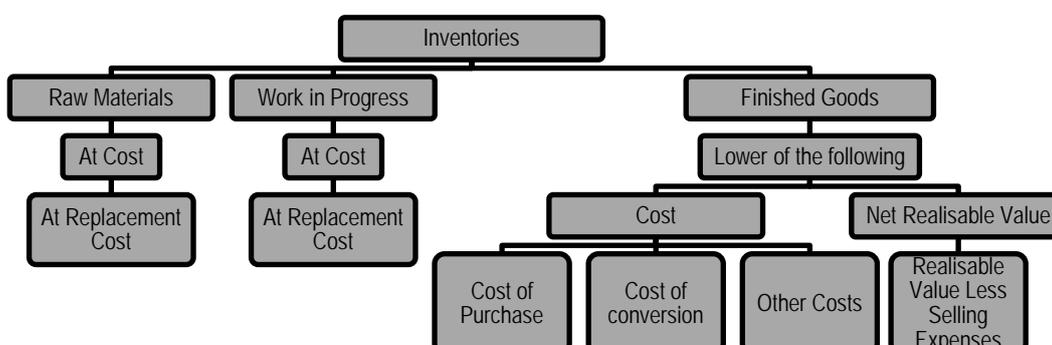
This Standard does not apply in accounting for the following inventories:

- (a) Work in progress arising under construction contracts, including directly related service contracts.
- (b) Work in progress arising in the ordinary course of business of service providers.
- (c) Shares, debentures and other financial instruments held as inventory-in-trade and
- (d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well-established practices in those industries.

3.2 Scope

AS 2 defines inventories as assets-

- (a) Held for sale in the ordinary course of business. It means finished goods ready for sale in case of a manufacturer and for traders, goods purchased by them with the intention of resale but not yet sold. These are known as Finished Goods.
- (b) In the process of production for such sale. These refer to the goods which are introduced to the production process but the production is not yet completed i.e. not fully converted into finished goods. These are known as Work-in-Progress.
- (c) In the form of materials or supplies to be consumed in the production process or in the rendering of services. It refers to all the materials and spares i.e. to be consumed in the process of production. These are known as Raw Materials.



3.3 Measurement of Inventories

Inventories should be valued at the lower of cost and net realisable value.

3.3.1 Cost of Inventories

Cost of goods is the summation of:

- (a) Cost of Purchase.
- (b) Cost of Conversion.
- (c) Other cost necessary to bring the inventory in present location and condition.

As shown in the above diagram, finished goods should be valued at cost or market price whichever is lower, in other words, finished goods are valued at the lower of cost or net realisable value.

Cost has three elements as discussed below:

Cost of Purchase Cost of purchase includes the purchase price plus all other necessary expenses directly attributable to purchase of inventory like, taxes and duties (other than those subsequently recoverable by the enterprise from the taxing authorities), carriage inward, loading/unloading excluding expenses recoverable from the supplier.

From the above sum, following items are deducted, duty drawback, CENVAT, VAT, trade discount, rebates.

Cost of Conversion For a trading company cost of purchase along with other cost (discussed below) constitutes cost of inventory, but for a manufacturer cost of inventory also includes cost of conversion. Readers can recollect the calculation of factory cost calculated in Cost Accounting:

Direct Material + Direct Labour = Prime Cost

Prime Cost + Factory Variable Overhead + Factory Fixed Overhead = Factory Cost.

Direct material is included in cost of purchase and the remaining items i.e. direct labour and overheads are termed as cost of conversion.

Direct labour is cost of workers in the unit who are directly associated with the production process, in other words we can say that direct labour is the cost of labour which can be directly attributed to the units of production.

Overheads are indirect expenses. Variable overheads are indirect expenses which is directly related to production i.e., it changes with the change in production in the same proportion (increase or decrease). Fixed overheads generally remains constant, it varies only when there is some major shift in production.

Since, direct labour and variable overheads are directly related with the production level, it is advisable to include them in cost of conversion on the basis of normal capacity. Because any difference between normal capacity and actual production will also bring in proportionate change in projected cost and actual cost.

For example: A unit is expected to produce 1 lacs units in a year with the projected labour cost ₹ 20 lacs and variable overhead ₹ 10 lacs. But the actual cost was only ₹ 18 lacs labour charges and ₹ 9 lacs overheads with production only 90,000 units. Now if we take these costs on normal capacity basis then direct labour is ₹ 20 per unit (20 lacs/1 lac) and variable overhead is ₹ 10 per unit (10 lacs/1 lac). Therefore, in cost of conversion we include direct labour (90,000 x 20) ₹ 18 lacs and variable overheads (90,000 x 10) ₹ 9 lacs.

Fixed overheads per unit are taken on the basis of normal capacity when actual production is equal to normal capacity or the difference is minor. In case when actual production increases normal capacity considerably, actual fixed overheads are included, however, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. When actual production is substantially less than normal capacity, fixed overhead per unit is included on the basis of normal capacity i.e. the amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred.

To understand the reason for such a provision we take an example

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

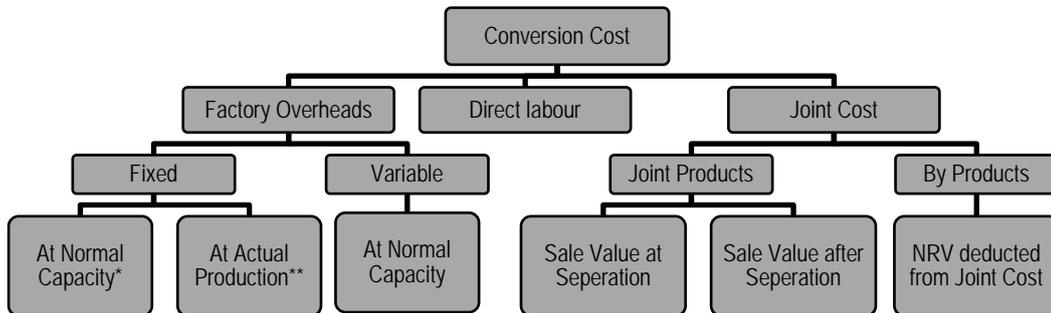
Case 1: Actual production is 1 lac units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of ₹ 18 lacs. Therefore it is advisable to include this on normal capacity.

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

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

Sometimes, a single production process may result in more than one product. In case, this additional product is the intended item and has a good market value, they are known as joint products. The cost of conversion incurred on all the production and not identifiable separately is allocated among the products on some rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the

production process when the products become separately identifiable, or at the completion of production. If this additional product doesn't have good market value then they are



considered as by-products. In this case, the net realisable value of the by-product is deducted from the total cost of conversion to calculate the cost of conversion for main product.

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

** When actual production is higher than normal capacity.

Other Costs Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

Exclusion from the Cost of Inventories

AS 2 gives the following as examples of costs that should be excluded from the cost of inventories and recognised as expenses in the period in which they are incurred:

- (a) Abnormal amounts of wasted materials, labour, or other production costs.
- (b) Storage costs, unless those costs are necessary in the production process prior to a further production stage.
- (c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition and
- (d) Selling and distribution costs.

Borrowing Costs

Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

There may, however, be few exceptions to the above rule. As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset. Accordingly, inventories that necessarily take a substantial period of time to bring them to a saleable condition are qualifying assets.

1.30 Financial Reporting

As per AS 16, for inventories that are qualifying assets, any directly attributable borrowing costs should be capitalised as part of their cost.

Illustration 1

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

Direct Labour	₹ 10,00,000
Direct Variable Overheads	₹ 1,00,000
Direct Fixed Overheads	₹ 1,00,000
(Including interest ₹ 40,625)	

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

Solution

Calculation of cost for closing inventory

Particulars	₹
Cost of Purchase (1,00,000 x 100)	1,00,00,000
Direct Labour	10,00,000
Variable Overhead	1,00,000
Fixed Overhead $\frac{(1,00,000 - 40,625)}{95,000}$	<u>59,375</u>
Cost of Production for normal output i.e. 95,000 MT	<u>1,11,59,375</u>
Cost of closing inventory per unit (1,11,59,375/95,000)	₹ 117.47 (approx)
Net Realisable Value per unit	₹ 105

Since, net realisable value is less than cost, closing inventory will be valued at ₹ 105. Therefore, closing inventory is ₹ 5,25,000 (5,000 x 105).

Note: Abnormal wastage of 10,000 MT i.e. 10,000 MT x ₹ 117.47 = ₹ 11,74,670 will be separately accounted for in the books.

Illustration 2

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

Item	Unit	Amount (₹)	Output (unit)	Closing inventory
Raw material	15,000	1,60,000	MP1-6,250	800
Wages	-	82,000	MP2- 5,000	200

Fixed overhead	-	58,000	BP-1,600	-
Variable overhead	-	40,000	-	-

Average market price of MP1 and MP2 is ₹ 80 per unit and ₹ 50 per unit respectively, by-product is sold @ ₹ 25 per unit. There is a profit of ₹ 5,000 on sale of by-product after incurring separate processing charges of ₹ 4,000 and packing charges of ₹ 6,000, ₹ 6,000 was realised from sale of scrap.

Calculate the value of closing inventory of MP1 and MP2.

Solution

As per para 10 of AS 2 'Valuation of Inventories', most by-products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realizable value and this value is deducted from the cost of the main product.

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

		₹
Selling price of by-product BP	(1,600 units x ₹ 25 per unit)	40,000
Less: Separate processing charges of by-product BP		(4,000)
Packing charges		<u>(6,000)</u>
Net realizable value of by-product BP		<u>30,000</u>

2. Calculation of cost of conversion for allocation between joint products MP1 and MP2

	₹	₹
Raw material		1,60,000
Wages		82,000
Fixed overhead		58,000
Variable overhead		<u>40,000</u>
		3,40,000
Less: NRV of by-product BP (See calculation 1)	(30,000)	
Sale value of scrap	<u>(6,000)</u>	<u>(36,000)</u>
Joint cost to be allocated between MP1 and MP2		<u>3,04,000</u>

3. Determination of "basis for allocation" and allocation of joint cost to MP1 and MP2

	MP1	MP2
Output in units (a)	6,250 units	5,000 units
Sales price per unit (b)	₹ 80	₹ 50
Sales value (a x b)	₹ 5,00,000	₹ 2,50,000
Ratio of allocation	2	1
Joint cost of ₹ 3,04,000 allocated in the ratio of 2:1 (c)	₹ 2,02,667	₹ 1,01,333
Cost per unit [c/a]	₹ 32.43	₹ 20.27

1.32 Financial Reporting

4. Determination of value of closing inventory of MP1 and MP2

	MP1	MP2
Closing inventory in units	800 units	200 units
Cost per unit	₹ 32.43	₹ 20.27
Value of closing inventory	₹ 25,944	₹ 4,054

3.4 Cost Formula

Following are the various cost formulae suggested by the standard:

Specific Identification Method It is suitable for the inventories where each unit of inventory along with their associated cost can be separately identified. In other words, it is suitable where one unit of inventory is not interchangeable with another unit. Under this method each unit is valued specifically on its original cost. Examples for such goods are ship building, machinery building.

The specific identification method is not appropriate for the routine production of inventories that are ordinarily interchangeable, since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

For items which are interchangeable, most appropriate method of cost valuation is either of the following two:

FIFO (First In First Out) It is assumed under this method that whatever is received first is issued first, which means, the inventory left over belongs to the latest purchases. Closing inventory is valued at the rates for the equivalent units purchased at last. During inflation inventory is valued at higher price and during decrease in price, inventory is valued at lower price.

Weighted Average Cost Under this method of inventory valuation, to determine the cost per unit, total cost of production during the year is divided by total units. In other words, for price per unit of the closing inventory we take the average price of the total goods purchased or produced during the year.

Following are cost formulae or techniques of measurement of cost suggested by the Accounting Standard for some special cases:

Standard Cost Method Inventories are valued on the basis of the set standards, which are realistic and reviewed regularly and where necessary, revised in the light of the current conditions. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation.

Retail Method It is recommended for retail business or in the business where the inventory comprises of many items, the individual costs of which are not readily ascertainable. All the inventories are valued at the selling price, which is then adjusted with normal gross profit ratio and selling expenses to reach at its cost.

Illustration 3

Ambica Stores is a departmental store, which sell goods on retail basis. It makes a gross profit of 20% on net sales. The following figures for the year-end are available:

Opening Inventory ₹ 50,000; Purchases ₹ 3,60,000; Purchase Returns ₹ 10,000; Freight Inwards ₹ 10,000; Gross Sales ₹ 4,50,000; Sales Returns ₹ 11,250; Carriage Outwards ₹ 5,000.

Compute the estimated cost of the inventory on the closing date.

Solution**Calculation of cost of closing inventory**

Particulars	₹
Opening Inventory	50,000
Purchases less returns (₹3,60,000 – ₹ 10,000)	3,50,000
Freight Inwards	<u>10,000</u>
	4,10,000
Less: Net Sales (₹ 4,50,000 – ₹ 11,250)	<u>(4,38,750)</u>
	(28,750)
Add: Gross Profits (₹ 4,38,750 x 20%)	<u>87,750</u>
Closing Inventory	<u>59,000</u>

3.5 Net Realisable Value (NRV)

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

When we say that inventory should be valued at the lower of cost or net realisable value, one should note that only under two circumstances cost of inventories will surpass its net realisable value:

1. The goods are damaged or obsolete and not expected to realise the normal sale price.
2. The cost necessary for the production of goods has gone up by greater degree.

Both the above cases we don't expect in the normal functioning of the business, hence whenever it is found that goods are valued at NRV, care should be taken to study the existing market position for the relevant products.

NRV of the goods are estimated on item to item basis and only items of the same characteristics are grouped together. Such estimation is made at the time of finalisation of accounts and circumstances existing on the date of balance sheet evident from the events after the balance sheet confirming the estimation should be taken into consideration. And assessment is made on each balance sheet date of such estimation.

While estimating the NRV, the purpose of holding the inventory should also be taken into consideration. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less

1.34 Financial Reporting

than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in AS 4, Contingencies and Events Occurring after the Balance Sheet Date.

For example, concern has 10,000 units in inventory, of which 6,000 is to be delivered for ₹ 40 each as per a contract with one of the customer. Cost of inventory is ₹ 45 and NRV estimated to be ₹ 50. In this case 6,000 units will be valued @ ₹ 40 each and rest 4,000 units will be valued @ ₹ 45 each.

This provision of cost or NRV whichever is less, is applicable to only those goods which are ready for sale i.e. finished goods. Since raw materials and work in progress are not available for sale, they don't have any realisable value and therefore NRV can never be estimated. For these goods statement suggests that these should always be valued at cost. Only exception is the case when the net realisable value of the relevant finished goods is lower than cost, in this case, the relevant raw materials and work in progress should be written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

Illustration 4

Particulars		Kg.	₹
Opening Inventory:	Finished Goods	1,000	25,000
	Raw Materials	1,100	11,000
Purchases		10,000	1,00,000
Labour			76,500
Overheads (Fixed)			75,000
Sales		10,000	2,80,000
Closing Inventory:	Raw Materials	900	
	Finished Goods	1200	

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

Solution

Calculation of cost for closing inventory

Particulars	₹
Cost of Purchase (10,200 x 10)	1,02,000
Direct Labour	76,500
Fixed Overhead $\frac{75,000 \times 10,200}{15,000}$	<u>51,000</u>
Cost of Production	<u>2,29,500</u>

Cost of closing inventory per unit (2,29,500/10,200)	₹ 22.50
Net Realisable Value per unit	₹ 20.00

Since net realisable value is less than cost, closing inventory will be valued at ₹ 20.

As NRV of the finished goods is less than its cost, relevant raw materials will be valued at replacement cost i.e. ₹ 9.50.

Therefore, value of closing inventory: Finished Goods (1,200 x 20)	₹ 24,000
Raw Materials (900 x 9.50)	<u>₹ 8,550</u>
	<u>₹ 32,550</u>

3.6 Disclosures

The financial statements should disclose:

- The accounting policies adopted in measuring inventories, including the cost formula used; and
- The total carrying amount of inventories together with a classification appropriate to the enterprise.

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

- raw materials and components,
- work in progress,
- finished goods,
- Stock-in-trade (in respect of goods acquired for trading),**
- stores and spares,
- loose tools, and
- Others (specify nature).**

Illustration 5

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

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

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

Solution

Valuation of Closing Inventory

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

Note: Since, 800 defective skirts were sold, the reduction in the price of the same had not been adjusted from the value of the closing inventory.

3.7 Illustrations

Illustration 6

State with reference to accounting standard, how will you value the inventories in the following cases:

- (i) Raw material was purchased at ₹ 100 per kilo. Price of raw material is on the decline. The finished goods in which the raw material is incorporated is expected to be sold at below cost. 10,000 kgs. of raw material is on inventory at the year end. Replacement cost is ₹ 80 per kg.
- (ii) In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is ₹ 1,000. The entire quantity of waste is on inventory at the year end.
- (iii) Per kg. of finished goods consisted of:

Material cost	₹ 100 per kg
Direct labour cost	₹ 20 per kg.
Direct variable production overhead	₹ 10 per kg.

Fixed production charges for the year on normal capacity of one lakh kgs. is ₹ 10 lakhs. 2,000 kgs. of finished goods are on inventory at the year end.

Solution

- (i) As per para 24 of AS 2 (Revised) on 'Valuation of Inventories', materials and other supplies held for use in the production of inventories are not written down below cost if the finished product in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

Hence, in the given case, the inventory of 10,000 kgs of raw material will be valued at ₹ 80 per kg. The finished goods, if on inventory, should be valued at net realisable value since it is expected to be sold below cost.

- (ii) As per para 13 of AS 2 (Revised), abnormal amounts of waste materials, labour or other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred.

In this case, normal waste is 250 MT and abnormal waste is 50 MT.

The cost of 250 MT will be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste amounting to ₹ 52,632 [(50 MT x (₹ 50,00,000 / 4,750 MT)] will be charged in the statement of profit and loss.

- (iii) In accordance with paras 8 and 9 of AS 2 (Revised), the costs of conversion include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Thus, cost per kg. of finished goods can be computed as follows:

	₹
Material cost	100
Direct labour cost	20
Direct variable production overhead	10
Fixed production overhead $\left(\frac{₹ 10,00,000}{1,00,000} \right)$	<u>10</u>
	<u>140</u>

Thus, the value of 2,000 kgs of finished goods on inventory at the year-end will be ₹ 2,80,000 (2,000 kgs. x ₹ 140).

Illustration 7

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2016-17, the historical cost and net realizable value of the items of closing inventory are determined as follows:

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

What will be the value of closing inventory?

Solution

As per para 14 of AS 2, the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced.

1.38 Financial Reporting

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

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

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

Illustration 8

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

<u>Raw material X</u>	
Closing balance	500 units
	<u>₹ per unit</u>
Cost price including excise duty	200
Excise duty (CENVAT credit is receivable on the excise duty paid)	10
Freight inward	20
Unloading charges	10
Replacement cost	150
<u>Finished goods Y</u>	
Closing Balance	1200 units
	<u>₹ per unit</u>
Material consumed	220
Direct labour	60
Direct overhead	40

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

Calculate the value of the closing stock, when

- Net Realizable Value of the Finished Goods Y is ₹ 400.
- Net Realizable Value of the Finished Goods Y is ₹ 300.

Solution

Statement showing valuation of Raw Material and Finished Goods at cost

Raw Material X	₹
Cost Price	200

Less: CENVAT credit	(10)
	190
Add: Freight Inward	20
Unloading charges	10
Cost	<u>220</u>
Finished goods Y	₹
Materials consumed	220
Direct labour	60
Direct overhead	40
Fixed overheads (2,00,000/20,000)	10
Cost	<u>330</u>

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

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

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

Accordingly, value of closing stock will be:

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

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

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

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

Accordingly, value of closing stock will be:

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

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

Reference: The students are advised to refer the full text of AS 2 "Valuation of Inventories" (revised 1999).

UNIT 4 : AS 3 : CASH FLOW STATEMENTS

4.1 Introduction

This statement came into effect in respect of accounting periods commenced on or after 1.4.1997. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June 1981. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1.4.2004 for the enterprises, which fall in the category of level I, at the end of the relevant accounting period. For all other enterprises though it is not compulsory but it is encouraged to prepare such statements. Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not supposed to disclose the figures for the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

4.2 Objective

Cash flow Statement (CFS) is an additional information provided to the users of accounts in the form of an statement, which reflects the various sources from where cash was generated (inflow of cash) by an enterprise during the relevant accounting year and how these inflows were utilised (outflow of cash) by the enterprise. This helps the users of accounts:

- ◆ To identify the historical changes in the flow of cash & cash equivalents.
- ◆ To determine the future requirement of cash & cash equivalents.
- ◆ To assess the ability to generate cash & cash equivalents.
- ◆ To estimate the further requirement of generating cash & cash equivalents.
- ◆ To compare the operational efficiency of different enterprises.
- ◆ To study the insolvency and liquidity position of an enterprise.
- ◆ As an indicator of amount, timing and certainty of future cash flows.
- ◆ To check the accuracy of past assessments of future cash flows
- ◆ In examining the relationship between profitability and net cash flow and the impact of changing prices.

Cash comprises cash on hand and demand deposits with banks.

Cash equivalents are short term (maximum three months of maturity from the date of acquisition), highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Example: Share Capital is not considered as cash equivalent even though they are readily convertible into cash because, the amount that will be realized on sale of investment is not determinable unless investment is actually sold. Similarly, fixed deposit for one year is also not

considered as cash equivalent because they are not readily convertible into cash, even though the amount is determinable.

One should not be confused with the concept of three months or less. As this standard states very clearly that three months or less from the date of acquisition, any investment which is not classified as cash equivalent cannot be reclassified as cash equivalent, even when the maturity period is less than three months. We should look at the status only on the date of acquisition and not later.

Cash flows are inflows and outflows of cash and cash equivalents.

4.3 Presentation of a Cash Flow Statement

AS 3 'Cash Flow Statements' requires the presentation of information about the historical changes in the cash and cash equivalents of an enterprise in the relevant accounting year by means of a cash flow statement, which classifies cash flows during the period according to operating, investing and financing activities.

4.3.1 Operating Activities

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

Examples of cash flows from operating activities are:

- cash received in the year from customers (in respect of sale of goods or services rendered either in the year, or in an earlier year, or received in advance in respect of the sale of goods or services to be rendered in a later year);
- cash payments in the year to suppliers (for raw materials or goods for resale whether supplied in the current year, or an earlier year, or to be supplied in a later year);
- the payment of wages and salaries to employees;
- tax and other payments on behalf of employees;
- the payment of rent on property used in the business operations; royalties received in the year;
- cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- the payment of insurance premiums;
- cash payments or refunds of income taxes that cannot be specifically identified with financing or investing activities
- cash flows arising from futures contracts, forward contracts, option contracts or swap contracts hedging a transaction that is itself classified as operating; and
- cash flows arising from the purchase and sale of securities and loans held for dealing or trading purposes.

4.3.2 Investing Activities

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

Examples of cash flows arising from investing activities include:

- cash payment to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;
- cash receipts from disposal of fixed assets (including intangibles);
- cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
- cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
- cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading purposes or the receipts are classified as financing activities.

4.3.3 Financing Activities

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

Examples of cash flows arising from financing activities are:

- cash proceeds from issuing shares or other similar instruments;
- cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
- cash repayments of amounts borrowed.

So all the transactions should be classified under each of these heads and presented in CFS, this kind of presentation gives a very clear idea to the users regarding the major sources of cash inflows, from where all the activities are financed by the enterprises. Say if net cash flow from

operating activities is negative and net cash flow from investing activities is positive, this does not portray a good picture of the functioning of the enterprise. Sometimes, a single transaction may include cash flows that are classified differently. For example, a fixed asset acquired out of loan taken from bank on deferred payment basis includes the loan element which will be classified under financing activities and the asset acquired will be classified under investing activities.

As discussed earlier, operating activities are those activities which determine the profit/loss result of the enterprise, hence this head helps us to determine that whether the concern has sufficient cash inflow from their normal operations to support their operating cash outflow, and also the other cash outflow.

There are few extraordinary items, which are recorded in Profit and Loss Account, but are not to be classified as operating activity, such as, profit/loss on sale of fixed asset. Fixed assets are to be classified as investing activities; therefore any sale proceeds from such items will go to investing activities. If investments are held as inventory in trade, in such a case we will disclose them as operating activities.

Illustration 1

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

- a. *Purchase of Machinery.*
- b. *Proceeds from issuance of equity share capital*
- c. *Cash Sales.*
- d. *Proceeds from long-term borrowings.*
- e. *Proceeds from Trade receivables.*
- f. *Cash receipts from Trade receivables.*
- g. *Trading Commission received.*
- h. *Purchase of investment.*
- i. *Redemption of Preference Shares.*
- j. *Cash Purchases.*
- k. *Proceeds from sale of investment*
- l. *Purchase of goodwill.*
- m. *Cash paid to suppliers.*
- n. *Interim Dividend paid on equity shares.*
- o. *Wages and salaries paid.*
- p. *Proceed from sale of patents.*
- q. *Interest received on debentures held as investment.*
- r. *Interest paid on Long-term borrowings.*

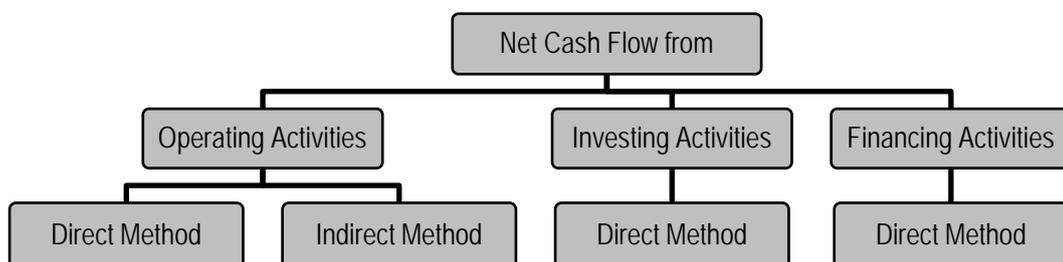
1.44 Financial Reporting

- s. *Office and Administration Expenses paid*
- t. *Manufacturing Overheads paid.*
- u. *Dividend received on shares held as investments.*
- v. *Rent Received on property held as investment.*
- w. *Selling and distribution expense paid.*
- x. *Income tax paid*
- y. *Dividend paid on Preference shares.*
- z. *Underwritings Commission paid.*
- aa. *Rent paid.*
- bb. *Brokerage paid on purchase of investments.*
- cc. *Bank Overdraft*
- dd. *Cash Credit*
- ee. *Short-term Deposits*
- ff. *Marketable Securities*
- gg. *Refund of Income Tax received.*

Solution

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

Cash Flow during the Year is



4.4 Reporting Cash Flows from Operating Activities

Net cash flow from operating activities can be reported either as direct method or as indirect method.

In 'Direct method' we take the gross receipts from sales, trade receivables and other operating inflows subtracted by gross payments for purchases, creditors and other expenses ignoring all non-cash items like depreciation, provisions. In 'Indirect method' we start from the net profit or loss figure, eliminate the effect of any non-cash items, investing items and financing items from such profit figure i.e. all such expenses like depreciation, provisions, interest paid, loss on sale of assets etc. are added and interest received etc. are deducted. Adjustment for changes in working capital items are also made ignoring cash and cash equivalent to reach to the figure of net cash flow.

Direct method is preferred over indirect because, direct method gives us the clear picture of various sources of cash inflows and outflows which helps in estimating the future cash inflows and outflows.

Below is the format for Cash Flow Statement

Cash Flow Statement of X Ltd. for the year ended March 31, 20XX (Direct Method)

<i>Particulars</i>	₹	₹
<i>Operating Activities:</i>		
Cash received from sale of goods	xxx	
Cash received from Trade receivables	xxx	
Cash received from sale of services	xxx	xxx
<i>Less:</i> Payment for Cash Purchases	xxx	
Payment to Trade payables	xxx	
Payment for Operating Expenses e.g. power, rent, electricity	xxx	
Payment for wages & salaries	xxx	
Payment for Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Indirect Method)

<i>Particulars</i>	₹	₹
Operating Activities:		
Closing balance of Profit & Loss Account	xxx	
<i>Less:</i> Opening balance of Profit & Loss Account	xxx	
	xxx	
Reversal of the effects of Profit & Loss Appropriation Account	xxx	
<i>Add:</i> Provision for Income Tax	xxx	
Effects of Extraordinary Items	xxx	

1.46 Financial Reporting

Net Profit Before Tax and Extraordinary Items	xxx	
Reversal of the effects of non-cash and non-operating items	xxx	
Effects for changes in Working Capital except cash & cash equivalent	xxx	
	xxx	
Less : Payment of Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Illustration 2

From the following information, calculate cash flow from operating activities:

*Summary of Cash Account
for the year ended March 31, 2017*

Particulars	₹	Particulars	₹
To Balance b/d	1,00,000	By Cash Purchases	1,20,000
To Cash sales	1,40,000	By Trade payables	1,57,000
To Trade receivables	1,75,000	By Office & Selling Expenses	75,000
To Trade Commission	50,000	By Income Tax	30,000
To Sale of Investment	30,000	By Investment	25,000
To Loan from Bank	1,00,000	By Repay of Loan	75,000
To Interest & Dividend	1,000	By Interest on loan	10,000
		By Balance c/d	1,04,000
	5,96,000		5,96,000

Solution

Cash Flow Statement of
for the year ended March 31, 2017 (Direct Method)

Particulars	₹	₹
Operating Activities:		
Cash received from sale of goods	1,40,000	
Cash received from Trade receivables	1,75,000	
Trade Commission received	50,000	3,65,000
Less: Payment for Cash Purchases	1,20,000	
Payment to Trade payables	1,57,000	
Office and Selling Expenses	75,000	
Payment for Income Tax	30,000	(3,82,000)
Net Cash used in Operating Activities		(17,000)

Illustration 3

Ms. Jyoti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year ended 31st March, 2017:

	(₹ in lakhs)
Net Profit	25,000
Dividend (including dividend tax) paid	8,535
Provision for Income tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets (net)	40
Book value of the assets sold	185
Depreciation charged to Profit & Loss Account	20,000
Amortisation of Capital grant	6
Profit on sale of Investments	100
Carrying amount of Investment sold	27,765
Interest income received on investments	2,506
Interest expenses	10,000
Interest paid during the year	10,520
Increase in Working Capital (excluding Cash & Bank Balance)	56,075
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrear	2
Receipt of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and Bank balance	5,003
Closing cash and Bank balance	6,988

Prepare the Cash Flow Statement for the year ended 31st March, 2017, in accordance with AS 3 'Cash Flow Statements' issued by the Institute of Chartered Accountants of India.

1.48 Financial Reporting

Solution

Star Oils Limited
Cash Flow Statement
for the year ended 31st March, 2017

	(₹ in lakhs)
Cash flows from operating activities	
Net profit before taxation (25,000 + 5,000)	30,000
Adjustments for :	
Depreciation	20,000
Loss on sale of assets (Net)	40
Amortisation of capital grant	(6)
Profit on sale of investments	(100)
Interest income on investments	(2,506)
Interest expenses	<u>10,000</u>
Operating profit before working capital changes	57,428
Changes in working capital (Excluding cash and bank balance)	<u>(56,075)</u>
Cash generated from operations	1,353
Income taxes paid	<u>(4,248)</u>
Net cash used in operating activities	<u>(2,895)</u>
Cash flows from investing activities	
Sale of assets (185 – 40)	145
Sale of investments (27,765 + 100)	27,865
Interest income on investments	2,506
Purchase of fixed assets	(14,560)
Investment in joint venture	(3,850)
Expenditure on construction work-in progress	<u>(34,740)</u>
Net cash used in investing activities	<u>(22,634)</u>
Cash flows from financing activities	
Proceeds from calls in arrear	2
Receipts of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceed from short-term borrowings	20,575
Interest paid	(10,520)
Dividend (including dividend tax) paid	<u>(8,535)</u>
	<u>27,514</u>
Net increase in cash and cash equivalents (27,514 – 22,634 – 2,895)	1,985
Cash and cash equivalents at the beginning of the period	<u>5,003</u>
Cash and cash equivalents at the end of the period	<u>6,988</u>

Illustration 4

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2017 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.

Summary Cash Account for the year ended 31.3.2017

	₹ '000		₹ '000
Balance on 1.4.2016	50	Payment to Suppliers	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from Customers	2,800	Overhead expense	200
Sale of Fixed Assets	100	Wages and Salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.3.2017	<u>150</u>
	<u>3,250</u>		<u>3,250</u>

Solution

X Ltd.

Cash Flow Statement for the year ended 31st March, 2017

(Using the direct method)

	₹ '000	₹'000
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	<u>(200)</u>	
Cash generated from operations	500	
Income tax paid	<u>(250)</u>	
Net cash from operating activities		250
Cash flows from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	<u>100</u>	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	

1.50 Financial Reporting

Bank loan repaid	(300)	
Dividend paid	<u>(50)</u>	
Net cash used in financing activities		<u>(50)</u>
Net increase in cash		100
Cash at beginning of the period		<u>50</u>
Cash at end of the period		<u>150</u>

Illustration 5

The summarised Balance Sheet of New Light Ltd. for the years ended 31st March, 2016 and 2017 are as follows:

Liabilities	31st March 2016 (₹)	31st March 2017 (₹)	Assets	31st March 2016 (₹)	31st March 2017 (₹)
Equity share capital	11,20,000	15,60,000	Fixed Assets	32,00,000	38,00,000
10% Preference share capital	4,00,000	2,80,000	Less: Depreciation	<u>9,20,000</u>	<u>11,60,000</u>
Capital Reserve	-	40,000	Investment	4,00,000	3,20,000
General Reserve	6,80,000	8,00,000	Cash	10,000	10,000
Profit and Loss A/c	2,40,000	3,00,000	Other current assets	11,10,000	13,10,000
9% Debentures	4,00,000	2,80,000			
Current liabilities	4,80,000	5,36,000			
Dividend	1,20,000	1,44,000			
Provision for Tax	<u>3,60,000</u>	<u>3,40,000</u>			
	<u>38,00,000</u>	<u>42,80,000</u>		<u>38,00,000</u>	<u>42,80,000</u>

Additional information:

- The company sold one fixed asset for ₹ 1,00,000, the cost of which was ₹ 2,00,000 and the depreciation provided on it was ₹ 80,000.
- The company also decided to write off another fixed asset costing ₹ 56,000 on which depreciation amounting to ₹ 40,000 has been provided.
- Depreciation on fixed assets provided ₹ 3,60,000.
- Company sold some investment at a profit of ₹ 40,000, which was credited to capital reserve.
- Debentures and preference share capital redeemed at 5% premium.
- Company decided to value inventory at cost, whereas previously the practice was to value inventory at cost less 10%. The inventory according to books on 31.3.2016 was ₹ 2,16,000. The inventory on 31.3.2017 was correctly valued at ₹ 3,00,000.

Prepare Cash Flow Statement as per revised AS 3 by indirect method.

Solution

New Light Ltd.
Cash Flow Statement for the year ended 31st March, 2017

	₹	₹
A.		
Cash Flow from operating activities		
Profit after appropriation		
Increase in profit and loss A/c after inventory adjustment [₹ 3,00,000 – (₹ 2,40,000 + ₹ 24,000)]	36,000	
Transfer to general reserve	1,20,000	
Dividend	1,44,000	
Provision for tax	<u>3,40,000</u>	
Net profit before taxation and extraordinary item	6,40,000	
Adjustments for:		
Depreciation	3,60,000	
Loss on sale of fixed assets	20,000	
Decrease in value of fixed assets	16,000	
Premium on redemption of preference share capital	6,000	
Premium on redemption of debentures	<u>6,000</u>	
Operating profit before working capital changes	10,48,000	
Increase in current liabilities (₹ 5,36,000 – ₹ 4,80,000)	56,000	
Increase in other current assets [₹ 13,10,000 – (₹ 11,10,000 + ₹ 24,000)] (W.N.1)	<u>(1,76,000)</u>	
Cash generated from operations	9,28,000	
Income taxes paid	<u>(3,60,000)</u>	
Net Cash from operating activities		5,68,000
B.		
Cash Flow from investing activities		
Purchase of fixed assets (W.N.3)	(8,56,000)	
Proceeds from sale of fixed assets	1,00,000	
Proceeds from sale of investments (W.N.2)	<u>1,20,000</u>	
Net Cash from investing activities		(6,36,000)
C.		
Cash Flow from financing activities		
Proceeds from issuance of share capital	4,40,000	
Redemption of preference share capital (₹1,20,000 + ₹ 6,000)	(1,26,000)	
Redemption of debentures (₹ 1,20,000 + ₹ 6,000)	(1,26,000)	
Dividend paid	<u>(1,20,000)</u>	

1.52 Financial Reporting

Net Cash from financing activities		<u>68,000</u>
Net increase/decrease in cash and cash equivalent during the year		Nil
Cash and cash equivalent at the beginning of the year		<u>10,000</u>
Cash and cash equivalent at the end of the year		<u>10,000</u>

Working Notes:

- Revaluation of inventory will increase opening inventory by ₹ 24,000.

$$\frac{2,16,000}{90} \times 10 = ₹ 24,000$$

Therefore, opening balance of other current assets would be as follows:

$$₹ 11,10,000 + ₹ 24,000 = ₹ 11,34,000$$

Due to under valuation of inventory, the opening balance of profit and loss account be increased by ₹ 24,000.

The opening balance of profit and loss account after revaluation of inventory will be

$$₹ 2,40,000 + ₹ 24,000 = ₹ 2,64,000.$$

- Investment Account**

		₹			₹
To	Balance b/d	4,00,000	By	Bank A/c	1,20,000
To	Capital reserve A/c (Profit on sale of investment)	<u>40,000</u>		(balancing figure being investment sold)	
		4,40,000	By	Balance c/d	<u>3,20,000</u>
					<u>4,40,000</u>

- Fixed Assets Account**

		₹			₹	₹
To	Balance b/d	32,00,000	By	Bank A/c (sale of assets)	1,00,000	
To	Bank A/c (balancing figure being assets purchased)	8,56,000	By	Accumulated depreciation A/c	80,000	
			By	Profit and loss A/c (loss on sale of assets)	<u>20,000</u>	2,00,000
			By	Accumulated depreciation A/c	40,000	
			By	Profit and loss A/c (assets written off)	<u>16,000</u>	56,000
		<u>40,56,000</u>	By	Balance c/d		<u>38,00,000</u>
						<u>40,56,000</u>

4. Accumulated Depreciation Account

	₹		₹
To Fixed assets A/c	80,000	By Balance b/d	9,20,000
To Fixed assets A/c	40,000	By Profit and loss A/c	
To Balance c/d	<u>11,60,000</u>	(depreciation for the period)	<u>3,60,000</u>
	<u>12,80,000</u>		<u>12,80,000</u>

Illustration 6

Financial information of Great Ltd. for the year ended 31st March, 2015 and 2016 are as follows:

**Summarised Balance Sheets of Great Ltd.
as on 31st March, 2016 and 2015**

	2016 ₹	2015 ₹
Assets		
Cash and cash equivalents	4,500	1,500
Trade receivables	7,500	3,750
Inventory	3,000	2,250
Intangible asset (net)	1,500	2,250
Due from associates	28,500	28,500
Property, plant and equipment at cost	18,000	33,750
Accumulated depreciation	(7,500)	(9,000)
Property, plant and equipment (net)	10,500	24,750
Total assets	55,500	63,000
Liabilities		
Accounts payable	7,500	18,750
Provision for taxation	7,500	4,500
Total liabilities	15,000	23,250
Shareholders' equity		
Share capital	9,750	9,750
Retained earnings	30,750	30,000
Total shareholders' equity	40,500	39,750
Total liabilities and shareholders' equity	55,500	63,000

**Summarised Statement of Profit and Loss of Great Ltd.
For the year ended 31st March, 2016**

	₹
Sales	45,000
Cost of sales	(15,000)

1.54 Financial Reporting

Gross operating profit	30,000
Administrative and selling expenses	(3,000)
Interest expenses	(3,000)
Depreciation of property, plant and equipment	(3,000)
Amortization of intangible asset	(750)
Investment income	4,500
Net profit before taxation	24,750
Taxes on profit	(6,000)
Net profit	18,750

Additional information:

- All sales made by Great Ltd. are credit sales. All purchases are also credit purchases.
- Interest expense for the year 2015-2016 was ₹ 3,000, which was fully paid during the year.
- The company pays salaries and other employee dues before the end of each month. All administration and selling expenses incurred were paid before 31st March, 2016.
- Investment income comprised dividend income from investments in shares of blue chip companies. This was received before 31st March, 2016.
- Equipment with a net book value of ₹ 11,250 and original cost of ₹ 15,750 was sold for ₹ 11,250.
- The company declared and paid dividends of ₹ 18,000 to its shareholders during 2015-2016.
- Income tax expense for the year 2015-2016 was ₹ 6,000, against which the company paid ₹ 3,000 during 2015-2016 as an estimate.

Using all the given financial information of Great Ltd., prepare the cash flows statement as per AS 3 under indirect method.

Solution

Cash Flow Statement of Great Ltd. For the year ended 31st March, 2016

	₹	₹
Cash flows from operating activities		
Net profit before taxation	24,750	
Adjustments for:		
Depreciation of property, plant, and equipment	3,000	
Amortization of intangible assets	750	
Investment income	(4,500)	
Interest expense	3,000	
Operating profit before working capital changes	27,000	
Increase in accounts receivable	(3,750)	
Increase in inventories	(750)	

Decrease in accounts payable	(11,250)	
Cash provided by operations	11,250	
Income taxes paid	(3,000)	
Net cash from operating activities		8,250
Cash flows from investing activities		
Proceeds from sale of equipment	11,250	
Dividends received	4,500	
Net Cash from investing activities		15,750
Cash flows from financing activities		
Dividends paid	(18,000)	
Interest paid	(3,000)	
Net Cash used in financing activities		<u>(21,000)</u>
Net increase in cash and cash equivalents		3,000
Cash and cash equivalents at the beginning of the year		<u>1,500</u>
Cash and cash equivalents at the end of the year		<u>4,500</u>

Illustration 7

Money Ltd., a non-financial company has the following entries in its Bank Account. It has sought your advice on the treatment of the same for preparing Cash Flow Statement.

(i) *Loans and Advances given to the following and interest earned on them:*

- (1) *to suppliers*
- (2) *to employees*
- (3) *to its subsidiaries companies*

(ii) *Investment made in subsidiary Smart Ltd. and dividend received*

(iii) *Dividend paid for the year*

(iv) *TDS on interest income earned on investments made*

(v) *TDS on interest earned on advance given to suppliers*

(vi) *Insurance claim received against loss of fixed asset by fire*

Discuss in the context of AS 3 Cash Flow Statement.

Solution

Treatment as per AS 3 'Cash Flow Statement'

(i) **Loans and advances given and interest earned**

- | | |
|------------------|--------------------------------------|
| (1) to suppliers | Cash flows from operating activities |
| (2) to employees | Cash flows from operating activities |

should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Business Purchase

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

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

Treatment of current assets and liabilities taken over on business purchase

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

4.6 Foreign Currency Cash Flows and Exchange Gains and Losses

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

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance sheet date. The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated exclusive of exchange gains and losses. The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement. (Paragraph 25)

4.7 Disclosures

Paragraph 45 requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by

1.58 Financial Reporting

management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

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

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

Reference: The students are advised to refer the full text of AS 3 “Cash Flow Statements” (revised 1997).

UNIT 5 : AS 4: CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

5.1 Introduction

All paragraphs of this Standard that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. 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) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet. Events occurring after the balance sheet date are those significant events (favourable as well unfavourable) that occur between the balance sheet date and the date on which financial statements are approved by the approving authority (i.e. board of directors in case of a company) of any entity.

This revised standard came into effect in respect of accounting periods commenced on or after 1.4.1995 and is mandatory in nature.

5.2 Contingencies

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. (Refer to unit 28 for discussion on AS 29)

5.3 Events Occurring after the Balance Sheet Date

Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

For example, for the year ending on 31st March 2017, financial statement is finalized and approved by the company in its AGM held on 04th September 2017. In this case the events taking place between 01st April 2017 to 04th September 2017 are termed as events occurring after the balance sheet date.

Two types of events can be identified

- a. those which provide further evidence of conditions that existed at the balance sheet date. For example a trade receivable declared insolvent and estate unable to pay full amount against whom provision for doubtful debt was created.
- b. those which are indicative of conditions that arose subsequent to the balance sheet date. An event which ceases the enterprise from being going concern.

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

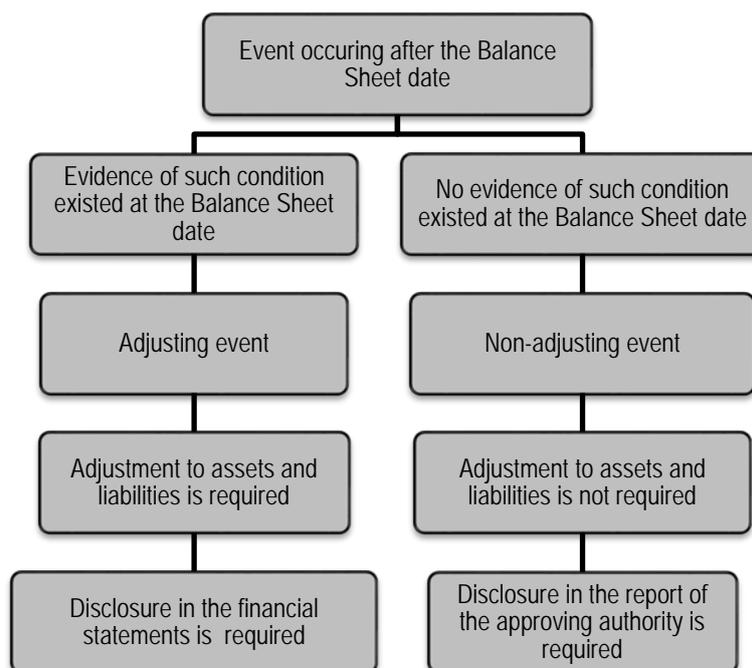
1.60 Financial Reporting

relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

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. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

There are events which, although 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.*

Assets and liabilities should be adjusted for events occurring after the balance sheet date that indicate that the fundamental accounting assumption of going concern (ie existence or substratum of the enterprise) is not appropriate.



5.4 Disclosure

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

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

5.5 Illustrations

Illustration 1

Pure Oil Ltd. closed the books of accounts on March 31, 2017 for which financial statement was finalized by the Board of Directors on September 04, 2017. During the month of December 2016, company undertook the project of laying a pipeline across the country and during May 2017 engineers realized that due to unexpected heavy rain, the total cost of the project will be inflated by ₹ 50 lakhs. How this should be provided for in the balance sheet of 2016-17 in accordance to AS 4?

Solution

This event occurred after March 31, 2017 but before September 04, 2017 is an event occurring after the balance sheet date. But this event is not affecting financial position on the date of balance sheet therefore it should be disclosed in the directors report.

Illustration 2

In preparing the financial statements of R Ltd. for the year ended 31st March, 2017, 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, 2017 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Solution

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 Approving Authority in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2017. 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, 2017 in the acquisition of another company should be disclosed in the report of the Approving Authority to enable users of financial statements to make proper evaluations and decisions.

Illustration 3

A Limited Company closed its accounting year on 30.6.2017 and the accounts for that period were considered and approved by the board of directors on 20th August, 2017. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2017 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 30.6.2017.

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 Report of Approving Authority.

Illustration 4

While preparing its final accounts for the year ended 31st March, 2017 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 2017 a trade receivable for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2017 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 2017?

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, 2017. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 2017, then mere disclosure required as per para 15, would have been sufficient.

Illustration 5

During the year 2015-2016, 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, 2016. On 18th May, 2016, 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, 2016, and approved by the board on 30th May, 2016.

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 2015-16 for which the provision was also made by it, the decision of the Court on 18th May, 2016, 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, 2016, it would be considered as post reporting period i.e. event occurred after the approval of the financial statements. In that case, no adjustment in the financial statements of 2015-16 would have been required.

Illustration 6

For seven companies whose financial year ended on 31st March, 2017, the financial statements were approved by their approving authority on 15th June, 2017.

During 2017-18, the following material events took place:

- a. A Ltd. sold a major property which was included in the balance sheet at ₹ 1,00,000 and for which contracts had been exchanged on 15th March, 2017. The sale was completed on 15th May, 2017 at a price of ₹ 2,50,000.
- b. On 30th April, 2017, a 100% subsidiary of B Ltd. declared a dividend of ₹ 3,00,000 in respect of its own shares for the year ended on 31st March, 2017.
- c. On 31st May, 2017, the mail order activities of C Ltd. (a retail trading group) were shut down with closure costs amounting to ₹ 2.5 million.
- d. On 1st July, 2017 the discovery of sand under D Ltd.'s major civil engineering contract site causes the cost of the contract to increase by 25% for which there would be no corresponding recovery from the customer.
- e. A fire, on 2nd April, 2017, completely destroyed a manufacturing plant of E Ltd. It was expected that the loss of ₹ 10 million would be fully covered by the insurance company.
- f. A claim for damage amounting to ₹ 8 million for breach of patent had been received by F Ltd. prior to the year-end. It is the director's opinion, backed by legal advice that the claim will ultimately

1.64 Financial Reporting

prove to be baseless. But it is still estimated that it would involve a considerable expenditure on legal fees.

- g. The change in foreign exchange rate of 8% between 1st April, 2017 and 1st June, 2017 has resulted in G Ltd.'s foreign assets being reduced by ₹ 1.3 million.*

You are required to state with reasons, how each of the above items numbered (a) to (g) should be dealt with in the financial statement of the various companies for the year ended 31st March, 2017.

Solution

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

(a)	A Ltd.	The sale of property should be treated as an adjusting event since contracts had been exchanged prior to the year-end. The effect of the sale would be reflected in the financial statements ended on 31.3.2017 and the profit on sale of property ₹ 1,50,000 would be treated as an extraordinary item.
(b)	B Ltd.	The declaration of dividend on 30 th April, 2017 of ₹ 3,00,000 would be treated as a non-adjusting event in the financial statements of 2016-17. This is because, the dividend has been declared after the balance sheet date and no conditions existed on the balance sheet date for such declaration of dividend. Further as per AS 9, right to receive dividend is established when it is declared and not before that.
(c)	C Ltd.	A closure not anticipated at the year-end would be treated as a non-adjusting event. Memorandum disclosure would be required for closure of mail order activities since non-disclosure would affect user's understanding of the financial statements.
(d)	D Ltd.	The event took place after the financial statements were approved by the approving authority and is thus outside the purview of AS 4. However, in view of its significance of the transaction, the directors may consider publishing a separate financial statement/additional statement for the attention of the members in general meeting.
(e)	E Ltd.	The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, it is necessary to consider the validity of the going concern assumption having regard to the extent of insurance cover. Also, since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of a note to the financial statements.
(f)	F Ltd.	On the basis of evidence provided, the claim against the company will not succeed. Thus, ₹ 8 million should not be provided in the account, but should be disclosed by means of a contingent liability with full details of the facts as per AS 9. Provision should be made for legal fee expected to be incurred to the extent that they are not expected to be recovered.

(g)	G Ltd.	The change in exchange rates is a non-adjusting event since it does not relate to the conditions existing at the balance sheet date. However, they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.
-----	--------	--

Reference: The students are advised to refer the full text of AS 4 "Contingencies* and Events occurring after the Balance Sheet Date".

* Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other AS.

UNIT 6 : AS 5: NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

6.1 Introduction

This revised standard AS 5 came into effect in respect of accounting periods commenced on or after 1.4.1996 and is mandatory in nature.

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

This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

6.2 Net Profit or Loss for the Period

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

- (a) **Profit or loss from ordinary activities:** Any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities. For example profit on sale of merchandise, loss on sale of unsold inventory at the end of the season.
- (b) **Extraordinary items:** Income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. For example, profit on sale of furniture or heavy loss of goods due to fire.

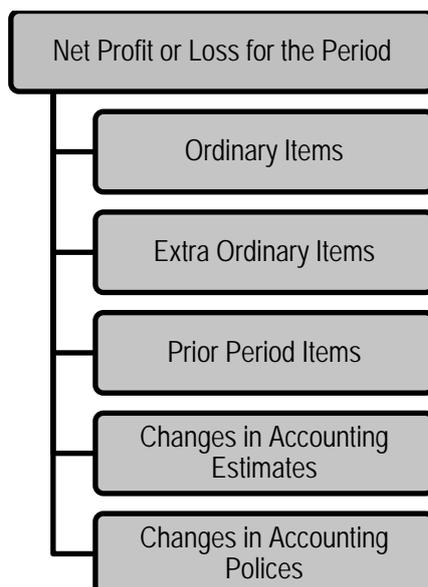
Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can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

When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Circumstances which may give rise to the separate disclosure of items of income and expense 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 the 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.
- (g) Other reversals of provisions.



6.3 Prior Period Items

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. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates.

6.4 Changes in Accounting Estimates

An estimate may have to be revised if changes occur in the circumstances based on which the estimate was made, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

- (a) The period of the change, if the change affects the period only; or
- (b) The period of the change and future periods, if the change affects both.

To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

For example, Sachin purchased a new machine costing ₹ 10 lacs. Useful life was taken to be for 10 years therefore depreciation was charged at 10% on original cost each year. After 5 years when carrying amount was ₹ 5 lacs for the machine, management realizes that machine can work for another 2 years only and they decide to write off ₹ 2.5 lacs each year. This is not an example of prior period item but change in accounting estimate. In the same example management by mistake calculates the depreciation in the fifth year as 10% of ₹ 6,00,000 i.e. ₹ 60,000 instead of ₹ 1,00,000 and in the next year decides to write off ₹ 1,40,000. ₹ 1,00,000 current year's depreciation and ₹ 40,000 as prior period item.

6.5 Changes in Accounting Policies

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. 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 the enterprise.

The following are not changes in accounting policies:

- (a) The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement;

(b) The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

Any change in an accounting policy which has a material effect should be disclosed. 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 such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Accounting Policies can be changed only:

- when the adoption of a different accounting policy is required by statute; or
- for compliance with an Accounting Standard; or
- when it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

6.6 Miscellaneous Illustrations

Illustration 1

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, 2008 to September, 2015 has been received and paid in February, 2016. However, the same was accounted in the year 2016-17. Comment on the accounting treatment done in the said case.

Solution

The final bill having been paid in February, 2016 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2016. 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 2016, this material charge has arisen in the current period i.e., year ended 31st March, 2017. 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 2

There was a major theft of stores valued at ₹ 10 lakhs in the preceding year which was detected only

1.70 Financial Reporting

during current financial year (2016-2017). How will you deal with this information in preparing the financial statements of R Ltd. for the year ended 31st March, 2017.

Solution

Due to major theft of stores in the preceding year (2015-2016) which was detected only during the current financial year (2016-2017), there was overstatement of closing inventory of stores in the preceding year. This must have also resulted in the overstatement of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year as 'Prior Period Items' as per AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. Accordingly, the adjustments relating to both opening inventory of the current year and profit brought forward from the previous year should be separately disclosed in the statement of profit and loss together with their nature and amount in a manner that their impact on the current profit or loss can be perceived.

Alternatively, it may be assumed that in the preceding year, the value of inventory of stores as found out by physical verification of inventories was considered in the preparation of financial statements of the preceding year. In such a case, only the disclosure as to the theft and the resulting loss is required in the notes to the accounts for the current year i.e., year ended 31st March, 2017.

Illustration 3

- (i) *During the year 2016-2017, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?*
- (ii) *A Limited company has been including interest in the valuation of closing inventory. In 2016-2017 the management of the company decided to follow AS 2 and accordingly interest has been excluded from the valuation of closing inventory. This has resulted in a decrease in profits by ₹ 3,00,000. Is a disclosure necessary? If so, draft the same.*
- (iii) *A company signed an agreement with the Employees Union on 1.9.2016 for revision of wages with retrospective effect from 30.9.2015. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2016-17?*

Solution

- (i) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Para 12 of AS 5 (Revised in 1997) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies states that:

"When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately."

Circumstances which may give to separate disclosure of items of income and expense in accordance with para 12 of AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

- (ii) As per AS 5 (Revised), change in accounting policy can be made for many reasons; one of these is for compliance with an accounting standard. In the instant case, the company has changed its accounting policy in order to conform to the AS 2 (Revised) on Valuation of Inventories. Therefore, a disclosure is necessary in the following lines by way of notes to the annual accounts for the year 2016-2017.

“To be in conformity with the Accounting Standard on Valuation of Inventories issued by ICAI, interest has been excluded from the valuation of closing stock unlike preceding years. Had the same principle been followed in previous years, profit for the year and its corresponding effect on the year end net assets would have been higher by ₹ 3,00,000.”

- (iii) It is given that revision of wages took place on 1st September, 2016 with retrospective effect from 30.9.2015. Therefore wages payable for the half year from 1.10.2016 to 31.3.2017 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item.

Additional wages liability of ₹ 7,50,000 (for 1½ years @ ₹ 5,00,000 per annum) should be included in current year's wages.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item. However, as per Para 12 of AS 5 (Revised), when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Illustration 4

While preparing its final accounts for the year ended 31st March, 2017 Rainbow Limited created a provision for Bad and Doubtful debts are 2% on trade receivables. A few weeks later the company found that payments from some of the major trade receivables were not forthcoming. Consequently the company decided to increase the provision by 10% on the trade receivables as on 31st March, 2017 as the accounts were still open awaiting approval of the Board of Directors. Is this to be considered as an extra-ordinary item or prior period item? Comment.

Solution

The preparation of financial statements involves making estimates which are based on the circumstances existing at the time when the financial statements are prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate does not bring the resulting amount within the definition either of prior period item or of an extraordinary item [para 21, AS 5 (Revised)].

In the given case, Rainbow Limited created a provision for bad and doubtful debts at 2% on trade receivables while preparing its final accounts for the year ended 31st March, 2017. Subsequently, the company decided to increase the provision by 10%. As per AS 5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.

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

1.72 Financial Reporting

Illustration 5

The company finds that the inventory sheets of 31.3.2016 did not include two pages containing details of inventory worth ₹ 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 2017.

Solution

Paragraph 4 of Accounting Standard 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, defines Prior Period items as "income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods".

Rectification of error in inventory valuation is a prior period item vide Para 4 of AS 5. ₹14.5 lakhs must be added to the opening inventory of 1.4.2016. It is also necessary to show ₹ 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

Illustration 6

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. Earlier 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.

Reference: The students are advised to refer the full text of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" .

UNIT 7 : AS 7: CONSTRUCTION CONTRACTS

7.1 Introduction

AS 7, came into effect in respect of all contracts entered into during accounting periods commenced on or after 1-4-2003 and is mandatory in nature. This Standard should be applied in accounting for construction contracts in the financial statements of contractors. The standard prescribes the accounting treatment of revenue and costs associated with construction contracts by laying down the guidelines regarding allocation of contract revenue and contract costs to the accounting periods in which the construction work is performed, since the construction activity is generally contracted and completed in more than one accounting period.

7.2 Definitions of the terms used in the Standard

A **construction contract** is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A **fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A **cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

7.3 Combining and Segmenting Construction Contracts

When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

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

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

- (a) The group of construction contracts is negotiated as a single package;
- (b) The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- (c) The contracts are performed concurrently or in a continuous sequence.

A construction contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

1.74 Financial Reporting

- (a) The asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
- (b) The price of the asset is negotiated without regard to the original contract price.

7.4 Contract Revenue

Contract revenue should comprise:

- (a) The initial amount of revenue agreed in the construction contract; and
- (b) Variations in contract work, claims and incentive payments:
 - (i) To the extent that it is probable that they will result in revenue; and
 - (ii) They are capable of being reliably measured.

Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

- (a) A contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;
- (b) The amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;
- (c) The amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or
- (d) When a fixed price contract involves a fixed price per unit of output, contract revenue increases/ decreases as the number of units is increased/ decreased.

7.5 Contract Costs

Contract costs should comprise:

- (a) Costs that relate directly to the specific contract;
 1. Site labour costs, including site supervision;
 2. Costs of materials used in construction;
 3. Depreciation of plant and equipment used on the contract;
 4. Costs of moving plant, equipment and materials to and from the contract site;
 5. Costs of hiring plant and equipment;
 6. Costs of design and technical assistance that are directly related to the contract;
 7. The estimated costs of rectification and guarantee work, including expected warranty costs; and
 8. Claims from third parties.

- (b) Costs that are attributable to contract activity in general and can be allocated to the contract; and
 - 1. Insurance;
 - 2. Costs of design and technical assistance that are not directly related to a specific contract; and
 - 3. Construction overheads.
 - 4. Borrowing costs capitalized under AS 16 "Borrowing Cost"
- (c) Such other costs as are specifically chargeable to the customer under the terms of the contract.

Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

- (a) General administration costs for which reimbursement is not specified in the contract;
- (b) Selling costs;
- (c) Research and development costs for which reimbursement is not specified in the contract; and
- (d) Depreciation of idle plant and equipment that is not used on a particular contract.

7.6 Recognition of Contract Revenue and Expenses

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately.

In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

- (a) Total contract revenue can be measured reliably;
- (b) It is probable that the economic benefits associated with the contract will flow to the enterprise;
- (c) Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
- (d) The contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when both the following conditions are satisfied:

- (a) It is probable that the economic benefits associated with the contract will flow to the enterprise; and

1.76 Financial Reporting

- (b) The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

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

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

When the outcome of a construction contract cannot be estimated reliably:

- (a) Revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
- (b) Contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately.

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

7.7 Disclosure

An enterprise should disclose:

- (a) The amount of contract revenue recognised as revenue in the period;
- (b) The methods used to determine the contract revenue recognised in the period; and
- (c) The methods used to determine the stage of completion of contracts in progress.

An enterprise should disclose the following for contracts in progress at the reporting date:

- (a) The aggregate amount of costs incurred and recognised profits (less recognised losses) to date
- (b) The amount of advances received; and
- (c) The amount of retentions.

Advances are recognized as liabilities until the related revenue is earned.

'Retentions' are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Retentions are recognized as receivables in the balance sheet of the contractor. An enterprise should present:

- (a) The gross amount due from customers for contract work as an asset; and
- (b) The gross amount due to customers for contract work as a liability.

7.8 Illustrations

Illustration 1

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2017.

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

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

Solution

(a)	Amount of foreseeable loss	(₹ in lakhs)
	Total cost of construction (500 + 105 + 495)	1,100
	Less: Total contract price	(1,000)
	Total foreseeable loss to be recognized as expense	<u>100</u>

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

1.78 Financial Reporting

(b)	Contract work-in-progress i.e. cost incurred to date are ₹ 605 lakhs	(₹ in lakhs)
	Work certified	500
	Work not certified	<u>105</u>
		<u>605</u>

This is 55% ($605/1,100 \times 100$) of total costs of construction.

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

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

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

= [605 + Nil – 100 – (400 + 140)] ₹ in lakhs

= [605 – 100 – 540] ₹ in lakhs

Amount due to customers = ₹ 35 lakhs

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

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

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

Illustration 2

On 1st December, 2016, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2017, the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2017 as per provisions of Accounting Standard 7 (Revised)?

Solution

	₹
Cost incurred till 31st March, 2017	64,99,000
Prudent estimate of additional cost for completion	<u>32,01,000</u>
Total cost of construction	97,00,000
Less: Contract price	<u>(85,00,000)</u>
Total foreseeable loss	<u>12,00,000</u>

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

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

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

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

Reference: The students are advised to refer the full text of AS 7 “Construction Contracts”.

UNIT 8 :AS 9: REVENUE RECOGNITION

8.1 Introduction

This standard was issued by ICAI in the year 1985 and in the initial years it was recommendatory for only level I enterprises and but was made mandatory for enterprise from April 01, 1993.

8.2 Revenue

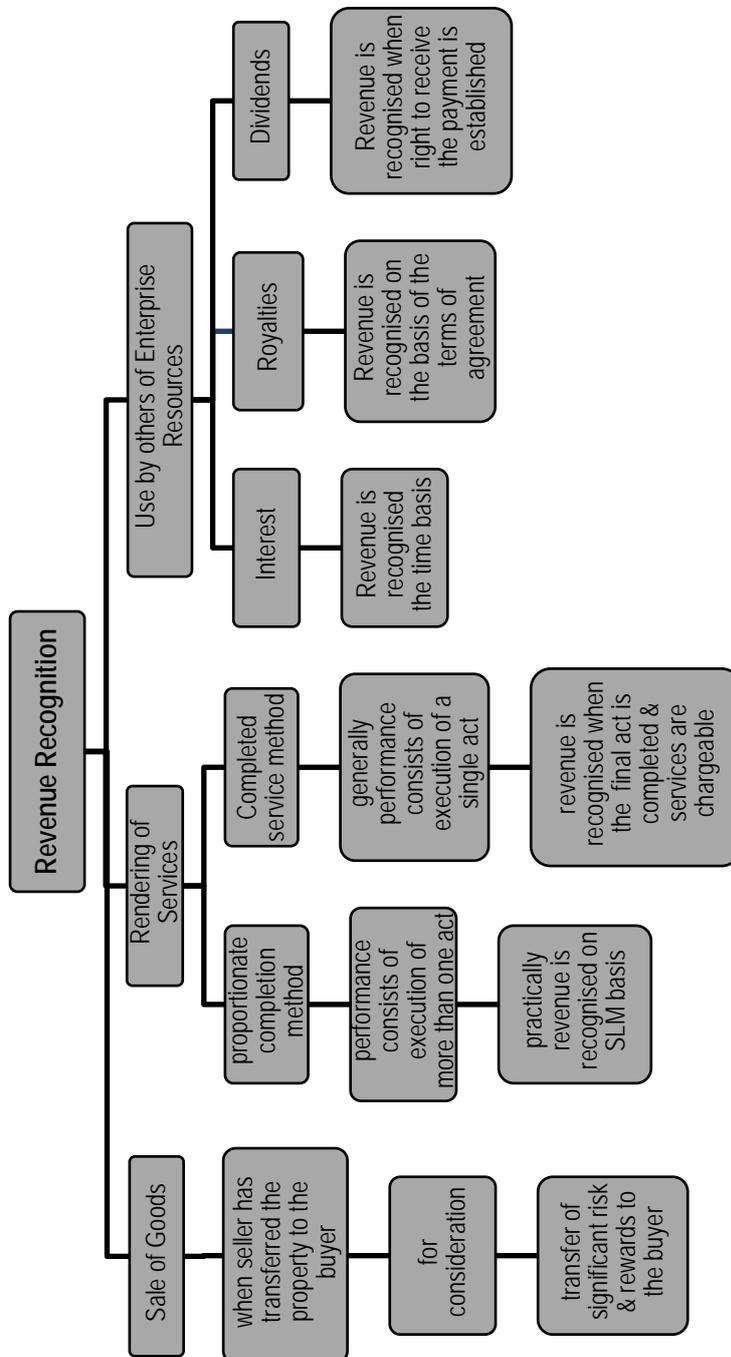
Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured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

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

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

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

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



8.3 Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

8.4 Rendering of Services

Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

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

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

8.5 Interest, Royalties and Dividends

The use by others of such enterprise resources gives rise to:

- (i) **Interest:** charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable. For example, debenture interest payable on every 30th June and 31st December. On March 31st when books will be closed, though interest has not fallen due

but still interest for the period January, February and March will be recognised on time basis.

- (ii) **Royalties:** charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement. If agreement is signed for royalty payable on the basis of the number of copies of the book published, it will be recognised on that basis only.
- (iii) **Dividends:** rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established. Unless company declare dividend on the shares, it is not certain. Therefore, it is recognised only when directors actually decides to pay dividend to their shareholders.

8.6 Effect of Uncertainties on Revenue Recognition

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

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

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

8.7 Disclosure

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

The amount of turnover should be disclosed in the following manner on the face of the statement of profit and loss:

Turnover (Gross)	XXXXX
Less: Excise Duty	<u>XXXXX</u>
Turnover (Net)	<u>XXXXX</u>

The amount of excise duty to be shown as deduction from turnover should be the total excise duty for the year except the excise duty related to the difference between the closing inventory and opening inventory. The excise duty related to the difference between the closing inventory and opening inventory should be recognised separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

8.8 Illustrations

Illustration 1

The stages of production and sale of a producer are as follows (all in Rupees):

Stage	Activity	Costs to date	Net Realisable Value
A	Raw Materials	10,000	8,000
B	WIP 1	12,000	13,000
C	WIP 2	15,000	19,000
D	Finished Product	17,000	30,000
E	Ready for Sale	17,000	30,000
F	Sale Agreed	17,000	30,000
G	Delivered	18,000	30,000

State and explain the stage at which you think revenue will be recognized and how much would be gross profit and net profit on a unit of this product?

Solution

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

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

Both these conditions are satisfied only at Stage F when sales are agreed upon at a price and goods allocated for delivery purpose.

Gross Profit will be determined at Stage E, when goods are ready for sale after all necessary process for production is over i.e. ₹ 13,000 (30,000 – 17,000).

Net Profit will be determined at Stage G, when goods are delivered and payment becomes due ₹ 12,000 (30,000 – 18,000).

Illustration 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2017. The details are given below:

Quantity of Gold	=	10,000 TT Bars
Gold Rate as on March 31, 2017	=	₹ 275 per TT Bar
Gold Rate was fixed on June 26, 2017 before the finalization of accounts of company	=	₹ 273 per TT Bar

Calculate the amount of inventory regarding 10,000 TT Bars to be booked in the company's account for the year ended March 31, 2017.

Solution

We need to refer to AS 4 along with AS 9 in this case, since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at ₹ 273 per TT Bar, gold will be valued at that rate.

Illustration 3

The Board of Directors decided on 31.3.2017 to increase the sale price of certain items retrospectively from 1st January, 2017. In view of this price revision with effect from 1st January 2017, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2017 to 31st March, 2017. Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2016-2017. Advise.

Solution

Price revision was effected during the current accounting period 2016-2017. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2017 to 31st March, 2017. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2016-2017 vide para 10 of AS 9.

Illustration 4

Y Ltd., used certain resources of X Ltd. In return X Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respectively from Y Ltd. during the year 2016-17. You are required to state whether and on what basis these revenues can be recognised by X Ltd.

Solution

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

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

Illustration 5

A claim lodged with the Railways in March, 2015 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 2017 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2017.

Solution

Prudence suggests non-consideration of claim as an asset in anticipation. So receipt of claims is generally recognised on cash basis. Para 9.2 of AS 9 on Revenue Recognition states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. Para 9.5 of AS 9 states that when recognition of revenue is postponed due to the effect of uncertainties, it is considered as

1.86 Financial Reporting

revenue of the period in which it is properly recognised. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only ₹ 1,50,000 were collected against a claim of ₹ 2,00,000. So this transaction can not be taken as a Prior Period Item.

In the light of revised AS 5, it will not be treated as extraordinary item. However, para 12 of AS 5 (Revised) states that when items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Accordingly, the nature and amount of this item should be disclosed separately as per para 12 of AS 5 (Revised).

Illustration 6

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2016-2017 the company wants to recognise the entire interest receivable. Do you agree?

Solution

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

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

Illustration 7

A Ltd. has sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31st March, 2017, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

Solution

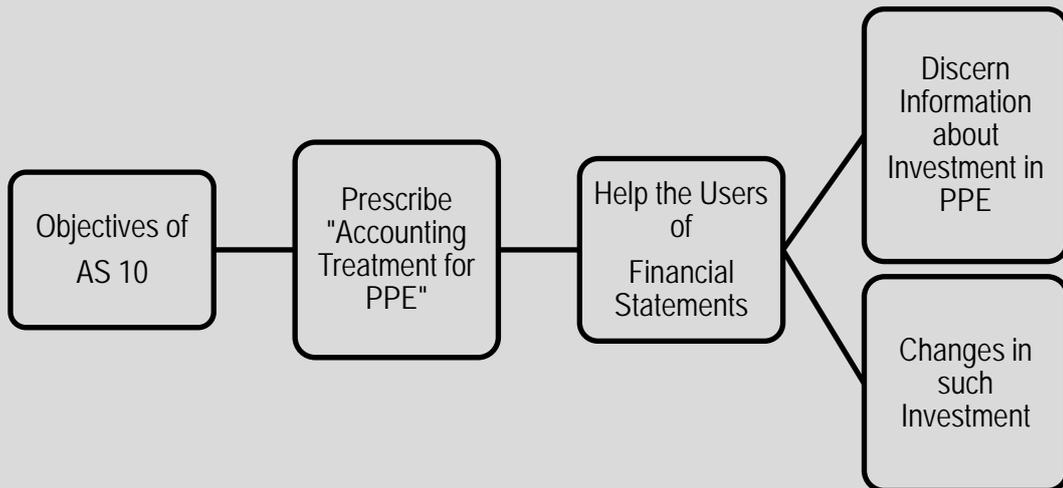
The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. A Ltd. should record the sale and recognize the profit of ₹ 20 lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

Reference: The students are advised to refer the full text of AS 9 “Revenue Recognition” (issued 1985).

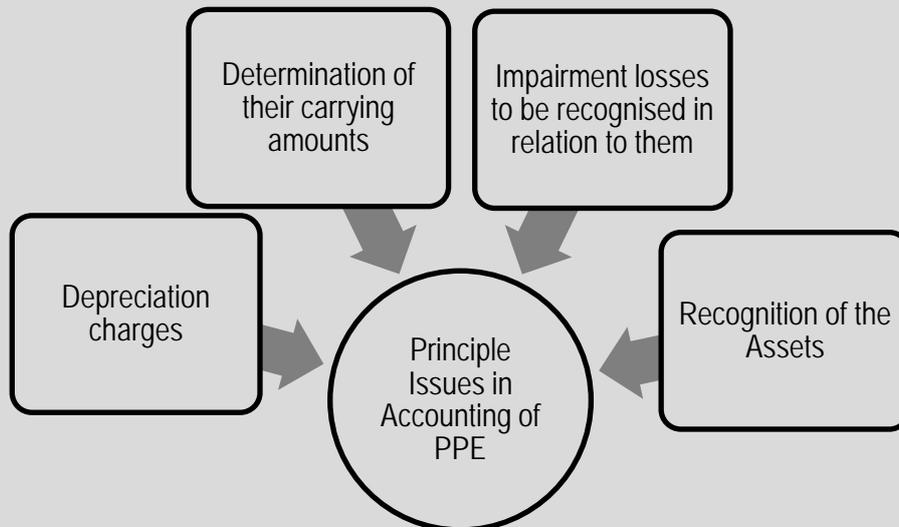
UNIT 9 : AS 10: PROPERTY, PLANT AND EQUIPMENT

9.1 Introduction

The objective of this Standard is to prescribe Accounting treatment for Property, Plant and Equipment (PPE). The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.



The principal issues in Accounting for PPE are:



9.2 Scope of the Standard

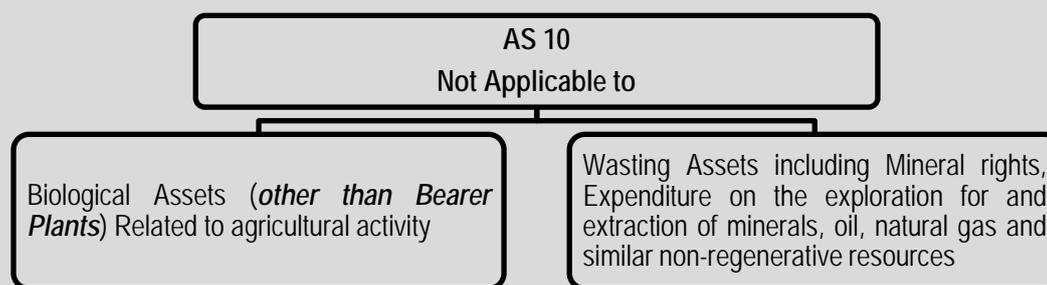
As a general principle, AS 10 should be applied in accounting for PPE.

Exception:

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

Example: AS 19 on Leases, requires an enterprise to evaluate its recognition of an item of leased PPE on the basis of the transfer of risks and rewards. However, it may be noted that in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

This Standard does not apply to:



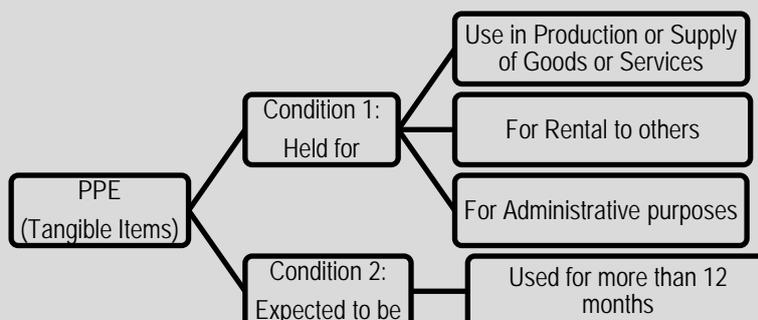
Note: AS 10 applies to Bearer Plants but it does not apply to the produce on Bearer Plants.

Clarifications:

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

9.3 Definition of Property, Plant and Equipment (PPE)

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



Note: Intangible items are covered under AS 26.

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

- Selling and distribution
- Finance and accounting
- Personnel and other functions

of an Enterprise.

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

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

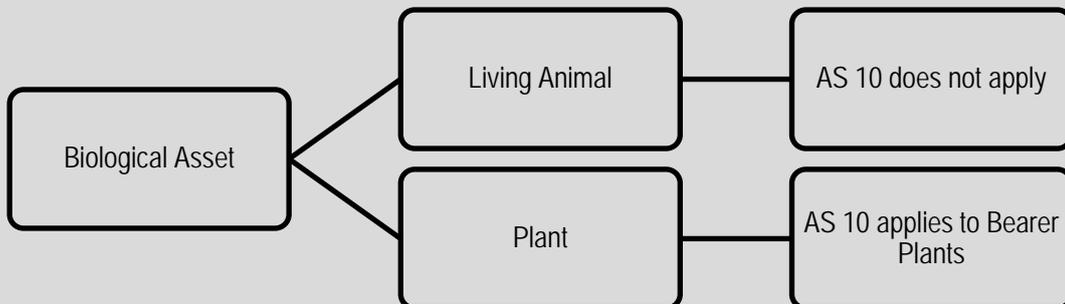
Such items of PPE qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

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

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

9.4 Other Definitions

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



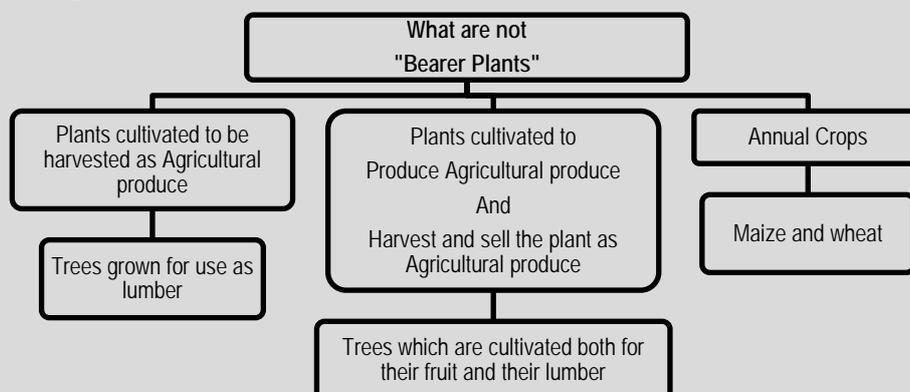
2. Bearer Plant: Is a plant that (satisfies all 3 conditions):

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

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

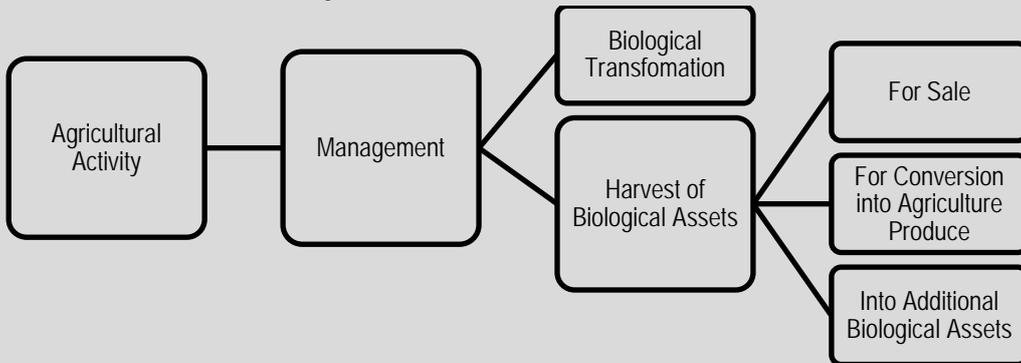
The following are not Bearer Plants:

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



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

3. **Agricultural Activity:** Is the **management** by an Enterprise of:
- Biological transformation; and
 - Harvest of Biological Assets
 - For sale, Or
 - For conversion into Agricultural Produce, Or
 - Into additional Biological Assets



9.5 Recognition Criteria for PPE

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

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

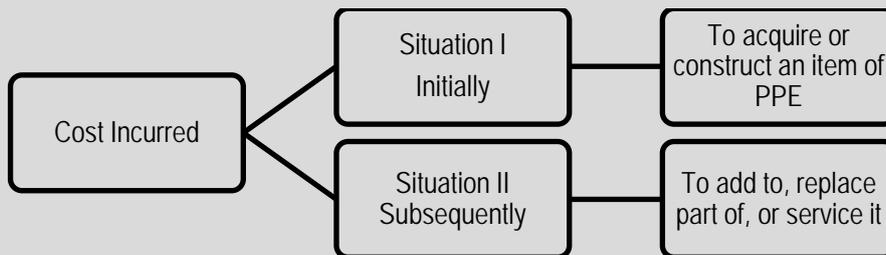
Notes:

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

When do we apply the above criteria for Recognition?

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

These costs include costs incurred:



9.6 Treatment of Spare Parts, Stand by Equipment and Servicing Equipment

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

- Recognised as PPE as per AS 10

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

- Such items are classified as Inventory as per AS 2

Illustration 1 (Capitalising the cost of "Remodelling" a Supermarket)

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

Solution

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

9.7 Treatment of Subsequent Costs

9.7.1 Cost of day-to-day servicing

Meaning:

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

Accounting Treatment:

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

9.7.2 Replacement of Parts of PPE

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

Examples:

1. A furnace may require relining after a specified number of hours of use.
2. Aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.

3. Major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system.
4. Replacing the interior walls of a building, or to make a non-recurring replacement.

Accounting Treatment:

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

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

9.7.3 Regular Major Inspections - Accounting Treatment

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

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

Illustration 2

What happens if the cost of the previous part/inspection was/ was not identified in the transaction in which the item was acquired or constructed? (Related to Issue 2 and 3)

Solution

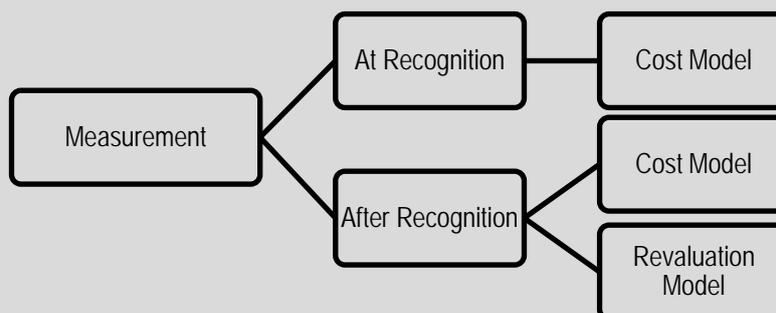
De-recognition of the carrying amount occurs **regardless** of whether the cost of the previous part/inspection was identified in the transaction in which the item was acquired or constructed.

Illustration 3

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

Solution

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

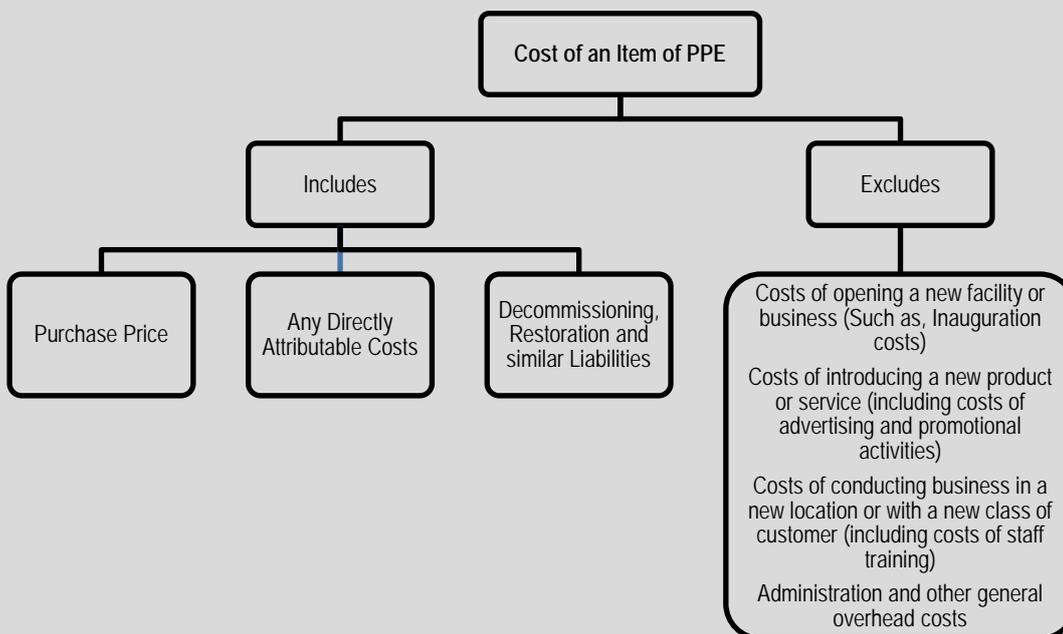
9.8 Measurement of PPE

9.9 Measurement at Recognition

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

What are the elements of Cost?

Cost of an item of PPE comprises:



Let us understand the above in detail.

A. Purchase Price:

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

B. Directly Attributable Costs:

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

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

Examples of directly attributable costs are:

1. Costs of employee benefits (as defined in AS 15) arising directly from the construction or acquisition of the item of PPE
2. Costs of site preparation
3. Initial delivery and handling costs

4. Installation and assembly costs
5. Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)
6. Professional fees

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

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

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

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

Illustration 4

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

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

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

Solution

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

Illustration 5 (Capitalisation of directly attributable costs)

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

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

Solution

Management should capitalise the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The supermarket cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset.

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

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

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

Solution

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

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

C. Decommissioning, Restoration and similar Liabilities:

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

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

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

9.10 Cost of a Self-constructed Asset

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

1. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see AS 2). Therefore, any **internal profits are eliminated** in arriving at such costs.
2. Cost of **abnormal amounts** of wasted material, labour, or other resources incurred in self constructing an asset is **not included** in the cost of the asset.
3. AS 16 on Borrowing Costs, establishes criteria for the **recognition of interest** as a component of the carrying amount of a self-constructed item of PPE.
4. **Bearer plants** are accounted for in the same way as self-constructed items of PPE before they are in the location and condition necessary to be capable of operating in the manner intended by management.

9.11 Measurement of Cost

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

A. If payment is deferred beyond normal credit terms:

Total payment - Cash price equivalent

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

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

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

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

Note:

1. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up.
2. If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.

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

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

Solution

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

Illustration 8 (Exchange of assets that lack commercial substance)

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

Solution

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

C. PPE purchased for a Consolidated Price:

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

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

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

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

E. Government Grant related to PPE:

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

9.12 Measurement after Recognition

An enterprise should choose

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

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

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

Examples of separate classes:

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

9.13 Cost Model

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

Cost - Any Accumulated Depreciation - Any Accumulated Impairment losses

9.14 Revaluation Model

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

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

9.14.1 Revaluation for entire class of PPE

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

Reason:

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

Illustration 9 (Revaluation on a class by class basis)

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

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

Solution

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

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

All properties within the class of office buildings must, therefore, be carried at revalued amount.

9.14.2 Frequency of Revaluations

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

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

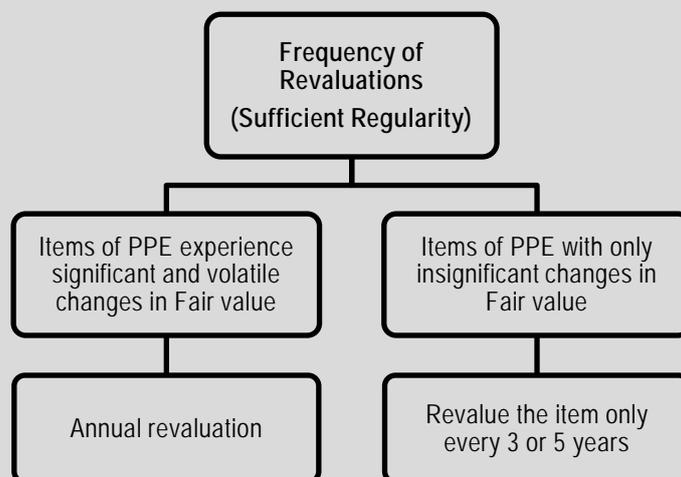
When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required.

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

Annual revaluation shall be done.

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

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



9.14.3 Determination of Fair Value

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

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

Example:

Based on

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

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

9.14.4 Accounting Treatment of Revaluations

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

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

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

Gross carrying amount

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

Accumulated depreciation at the date of the revaluation is

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

Case Study on Technique I

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

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

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

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

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

Case Study on Technique II

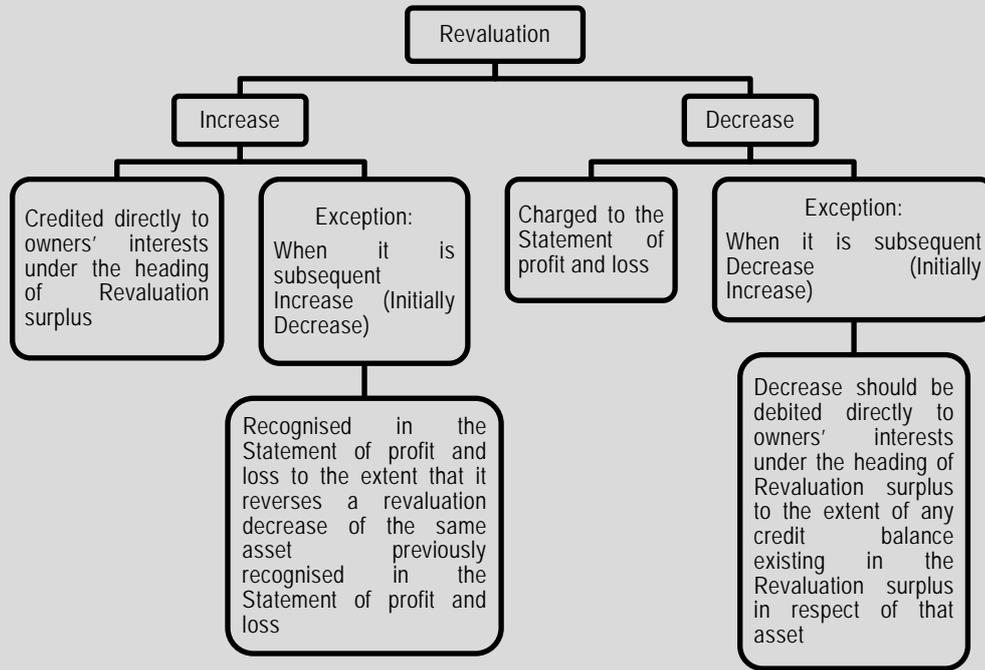
(Taking the information given in the above Example)

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

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

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

9.14.5 Revaluation - Increase or Decrease



9.14.6 Treatment of Revaluation Surplus

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

Case I : When whole surplus is transferred:

When the asset is:

- Retired; Or
- Disposed of

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

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

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

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

9.15 Depreciation

Component Method of Depreciation:

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

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

Is Grouping of Components possible?

Yes.

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

Accounting Treatment:

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

Examples on Exception:

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

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

9.16 Depreciable Amount and Depreciation Period

9.16.1 What is “Depreciable Amount”?

Depreciable amount is:

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

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

Illustration 10

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

Solution

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

Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use.

9.16.2 Review of Residual Value and Useful Life of an Asset

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

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

Illustration 11 (Change in estimate of useful life)

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

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

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

Solution

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

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

The remaining useful life is 4 years.

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

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

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

9.16.3 Commencement of period for charging Depreciation

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

Illustration 12

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

Solution

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

9.16.4 Cessation of Depreciation

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

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

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

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

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

Case (a) ₹ 10,00,000

Case (b) ₹ 9,00,000.

Calculate the amount of depreciation.

Solution

Case (a)

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

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

Case (b)

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

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

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

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

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

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

9.16.5 Land and Buildings

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

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

Exceptions: Quarries and sites used for landfill.

Depreciation on Land:

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

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

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

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

B. Buildings:

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

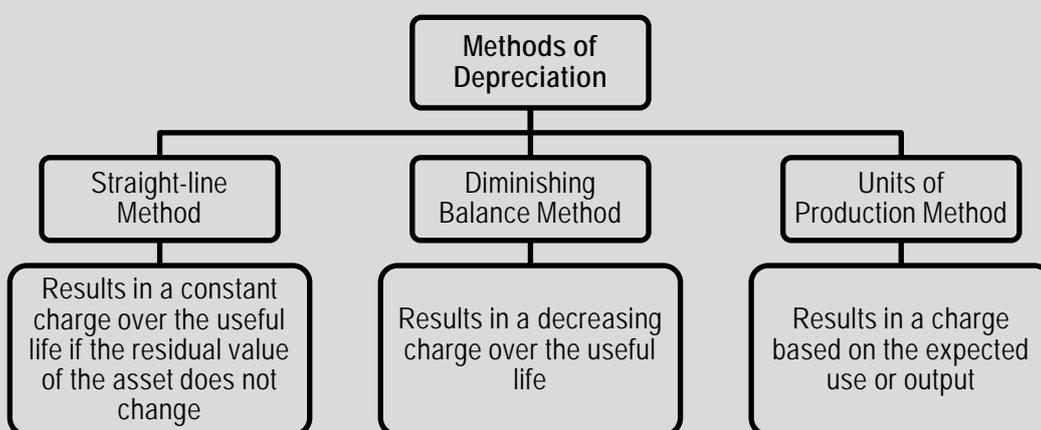
An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

9.17 Depreciation Method

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

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

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



Review of Depreciation Method:

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

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

Depreciation Method based on Revenue:

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

Illustration 14 (Determination of appropriate Depreciation Method)

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

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

Solution

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

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

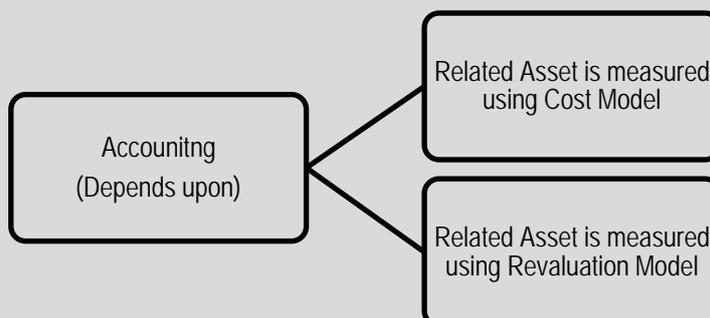
9.18 Changes in Existing Decommissioning, Restoration and other Liabilities

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

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

The above are **included in the cost of the asset**.

Accounting for the above changes:



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

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

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

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

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

Note: If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with AS 28.

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

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

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

Exception:

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

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

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

Exception:

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

Caution:

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

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

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

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

9.19 Impairment

To determine whether an item of PPE is impaired, an enterprise applies AS 28 on Impairment of Assets.

AS 28 explains how an enterprise:

- Reviews the carrying amount of its Assets
- How it determines the Recoverable Amount of an Asset, and
- When it Recognises, or Reverses the recognition of, an Impairment loss

9.20 Compensation for Impairment

Compensation from third parties for items of PPE that were impaired, lost or given up should be included in the Statement of Profit and Loss when the **compensation becomes receivable**.

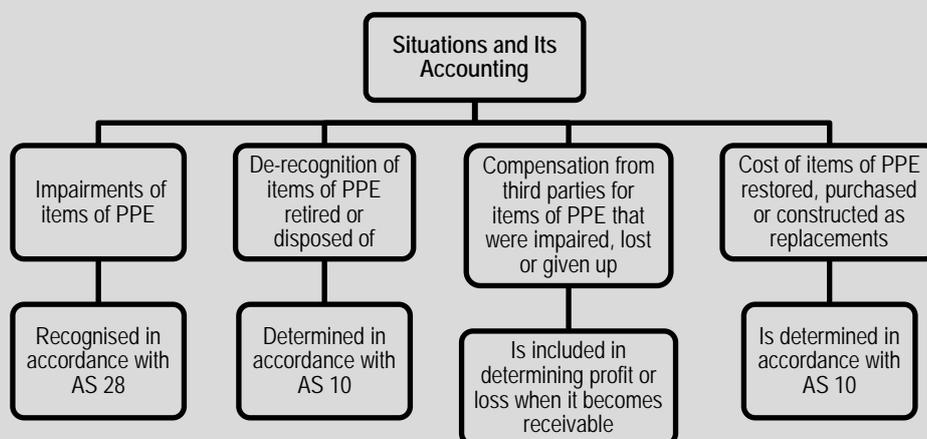


Illustration 15 (Gain on replacement of Insured Assets)

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

Solution

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

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

9.21 Retirements

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

- Carrying Amount, and
- Net Realisable Value

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

9.22 De-recognition

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

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

Accounting Treatment:

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

Where,

Gain or loss arising from de-recognition of an item of PPE

$$= \text{Net disposal proceeds (if any)} - \text{Carrying Amount of the item}$$

Note: Gains should **not** be classified as revenue, as defined in AS 9 'Revenue Recognition'.

Exception:

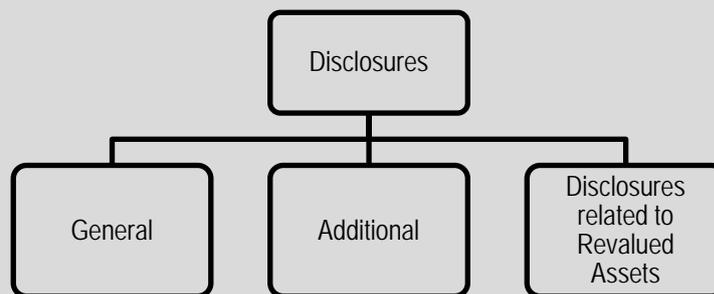
An enterprise that in the course of its ordinary activities, routinely sells items of PPE that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale.

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

Determining the date of disposal of an item:

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

9.23 Disclosure



9.23.1 General Disclosures:

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

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

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

- (d) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
- (e) A reconciliation of the carrying amount at the beginning and end of the period showing:

9.23.2 Additional Disclosures:

The financial statements should also disclose:

- (a) The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
- (b) The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;

- (c) The amount of contractual commitments for the acquisition of property, plant and equipment;
- (d) If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and
- (e) The amount of assets retired from active use and held for disposal.

9.23.3 Disclosures related to Revalued Assets:

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

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

9.24 Transitional Provisions

9.24.1 Previously Recognised Revenue Expenditure

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

- It may do so **retrospectively** for such a project.

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

9.24.2 PPE acquired in Exchange of Assets

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

9.24.3 Spare parts

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

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

9.24.4 Revaluations

The requirements of AS 10 regarding the revaluation model should be **applied prospectively**.

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

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

Reference: The students are advised to refer the full text of AS 10 "Property, Plant and Equipment" (Revised 2016).

UNIT 10 : AS 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

10.1 Introduction

AS 11, (revised 2003), came into effect in respect of accounting periods commenced on or after 1-4-2004 and is mandatory in nature from that date. The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognize the financial effects of changes in exchange rates in the financial statements. The standard requires the enterprises to disclose

- (i) the amount of exchange differences included in the net profit or loss for the period
- (ii) the amount of exchange differences adjusted in the carrying amount of fixed assets,
- (iii) the amount of exchange differences in respect of forward exchange contracts to be recognized in the profit or loss in one or more subsequent accounting periods (over the life of the contract).

10.2 Scope

This Standard 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 Standard does not:

- (a) Specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, the Standard requires disclosure of the reasons for using that currency. The Standard also requires disclosure of the reason for any change in the reporting currency.
- (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, which are addressed in AS 3 'Cash flow statement'.
- (c) Deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

- (d) Deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

10.3 Definitions of the terms used in the Standard

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.

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.

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.

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.

'Net investment in a non-integral foreign operation' is the reporting enterprise's share in the net assets of that operation.

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.

'Foreign currency' is a currency other than the reporting currency of an enterprise

10.4 Initial Recognition

A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and 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.

10.5 Reporting at each balance sheet date

The treatment of foreign currency items at the balance sheet date depends on whether the item is:

- monetary or non-monetary; and
 - carried at historical cost or fair value (for non-monetary items).
- (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.

10.6 Recognition of Exchange Differences

Exchange differences arise on:

- the settlement of monetary items at a date subsequent to initial recognition; and
- remeasuring an enterprise's monetary items at rates different from those at which they were either initially recorded (if in the period) or previously recorded (at the previous balance sheet date).

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

1.118 Financial Reporting

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. However, 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.

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.

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 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.

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.

Further in December, 2011, the Ministry of Corporate Affairs inserted para 46A in AS 11 of the Companies (Accounting Standards) Rules, 2006. According to it, in respect of accounting periods commencing on or after the 1st April, 2011, an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise, 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.**

Such option is irrevocable and should be applied to all such foreign currency monetary items. The enterprise exercising such option 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.

10.7 Classification of Foreign Operations as Integral or Non-integral

The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either 'integral foreign operations' or 'non-integral foreign operations'.

An integral foreign operation carries on its business as if it were an extension of the reporting enterprise's operations. For example, such an operation might only sell goods imported from the reporting enterprise and remits the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. 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.

10.8 Translation of Foreign Integral Operations

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. 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. 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.

10.9 Translation of Non-Integral Foreign Operations

The translation of the financial statements of a non-integral foreign operation is done using the 'closing rate method' in which the following procedures are used:

- (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 (AS 21 and AS 27). 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 (AS 21).
- (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.

10.10 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.

10.11 Tax Effects of Exchange Differences

Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22.

10.12 Forward Exchange Contract

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 1

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 when 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

It is apparent from the facts given in the question that Mr. A entered into forward exchange contract for speculation purpose*. According to paragraphs 38 and 39 of AS 11(Revised) 'The Effects of Changes in Foreign Exchange Rates', gain or loss on forward exchange contracts intended for trading or speculation purpose should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period and the premium or discount on the forward exchange contract is ignored and not recognised separately. In recording such contract, 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.

Thus, the premium on contract i.e., the difference between the contract rate and the spot rate amounting ₹ 8,000 [US \$ 1,00,000 x (₹ 47.10 – ₹ 47.02)] will be ignored and not be recorded in the books. However, the profit on contract i.e. the difference between the sale rate and contract rate amounting ₹ 8,000 [US\$ 1,00,000 x 0.08 (₹ 47.18 – ₹ 47.10)] will be recognised in the books of Mr. A on 31st January.

*The forward contract is sold before its due date, hence considered as speculative.

Note: *The current market value of the forward contract on 31st December has not been given in the question. Therefore, no gain or loss can be recognised in the books on 31st December. The profit amounting ₹ 8,000 will be recognised in the year of sale only.

10.13 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.

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.

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

In the format of Schedule III to the Companies Act, 2013, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". 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. Therefore, 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.

10.15 Miscellaneous Illustrations

Illustration 2

A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.2016 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 1.1.2016 and 31.12.2016 respectively. First instalment was paid on 31.12.2016. The entire difference in foreign exchange has been capitalized.

You are required to state, how these transactions would be accounted for.

1.124 Financial Reporting

Solution

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

Calculation of Exchange Difference:

$$\text{Foreign currency loan} = \frac{\text{₹ 3,000 lakhs}}{\text{₹ 40}} = 75 \text{ lakhs US Dollars}$$

$$\text{Exchange difference} = 75 \text{ lakhs US Dollars} \times (42.50 - 40.00) = \text{₹187.50 lakhs}$$

(including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting ₹ 187.50 lakhs should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not exercised the option of capitalization available under para 46 of AS 11. However, if the company opts to avail the benefit given in para 46A, then nothing is required to be done since the company has done the correct treatment.

Illustration 3

Assets and liabilities and income and expenditure items in respect of foreign branches are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to revenue. Comment.

Solution

The financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures described in paragraphs 8 to 16 of AS 11 (Revised 2003). The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. For practical reasons, a rate that approximates the actual rate at the date of transaction is often used, for example, an average rate for a week or a month may be used for all transactions in each foreign currency during the period. The foreign currency monetary items (for example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account. Exchange difference arising on the translation of the financial statement of foreign operation may have tax effect which should be dealt as per AS 22

'Accounting for Taxes on Income'.

Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11 (Revised 2003).

Note: The above answer has been given on the basis that the foreign branches referred in the question are integral foreign operations.

Illustration 4

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, 2016, 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 capitalised even though the company had an option to capitalise 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 capitalising the same to the cost of asset. Exchange rate on 31st March, 2017 is 1 US \$ = ₹ 51. Assume that on 31st March, 2017, Option Ltd. is not having any old Long term foreign currency borrowings except for the amount borrowed for machinery purchased on 1st April, 2016.

Can Option Ltd. capitalise the exchange difference to the cost of asset on 31st March, 2017? If yes, then calculate the depreciation amount on machineries as on 31st March, 2017.

Solution

Ministry of Corporate Affairs 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 1 st April, 2016		₹ 52 = 1\$
Cost of the asset in ₹	(\$ 10 lakhs x ₹ 52)	520 lakhs
Less: Exchange differences as on 31 st March, 2017 (52-51) x \$ 1 million	(Gain)	(10 lakhs)
		510 lakhs
Less: Depreciation for 2016-17	(510 lakhs - 20 lakhs)/10 years	(49 lakhs)
		<u>461 lakhs</u>

Reference: The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates" (revised 2003).

UNIT 11 :AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

11.1 Introduction

The Standard came into effect in respect of accounting periods commenced on or after 1.4.1992 and was recommendatory in nature for an initial period of two years. AS 12 deals with accounting for government grants like subsidies, cash incentives, duty drawbacks, etc. and specifies that the government grants should not be recognized until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received. The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets, revenue, promoters' contribution; treatment for refund of government grants etc. The enterprises are required to disclose

- (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 non-monetary grants of assets given either at a concessional rate or free of cost.

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.

11.2 Accounting Treatment of Government Grants

Two broad approaches may be followed for the accounting treatment of government grants:

- 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.

11.3 Recognition of Government Grants

A government grant is not recognised until there is reasonable assurance that:

- the enterprise will comply with the conditions attaching to it; and
- the grant will be received.

Receipt of a grant is not of itself conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

11.4 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.

11.5 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.

Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. 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.

Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

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. However, 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.

11.6 Presentation of Grants Related to Revenue

AS 12 permits two methods of presentation in the financial statements for grants related to income:

1. directly as a credit to the statement of profit and loss, either separately or under a general heading such as 'other income'; or
2. as a deduction in reporting the related expense.

11.7 Presentation of Grants in 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.

11.8 Refund of Government Grants

Government grant sometimes become refundable because certain conditions are not fulfilled and is 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 capital reserve or 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.

11.9 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 recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

11.10 Miscellaneous Illustrations

Illustration 1

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.2017. You are required to advise the company on the following item from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards:

The company purchased on 01.04.2016 special purpose machinery for ₹ 25 lakhs. It received a Central Government Grant for 20% of the price. The machine has an effective life of 10 years.

Solution

AS 12 'Accounting for Government Grants' regards two methods of presentation, of grants related to specific fixed assets, in financial statements as acceptable alternatives. Under the first method, the grant can be shown as a deduction from the gross book value of the machinery in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

Under the second method, it can be treated as deferred income which should be recognised in the profit and loss statement over the useful life of 10 years in the proportions in which depreciation on machinery will be charged. The deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description e.g., 'Deferred government grants' to be shown after 'Reserves and Surplus' but before 'Secured Loans'.

The following should also be disclosed:

- (i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;
- (ii) the nature and extent of government grants recognised in the financial statement of ₹ 5 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 2

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of ₹ 50 crore in capital assets received ₹ 10 crore from the Government in January, 2017 (accounting period being 2016-2017). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2017.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.

Solution

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus it is inappropriate to recognise government grants in the profit and loss statement, since

1.130 Financial Reporting

they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment followed by the company is not proper.

Illustration 3

On 1.4.2014, ABC Ltd. received Government grant of ₹ 300 lakhs for acquisition of machinery costing ₹ 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 2017 due to non-fulfillment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd.?

Solution

According to para 21 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing deferred income balance, as appropriate, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(₹ in lakhs)
1st April, 2014	Acquisition cost of machinery (₹ 1,500 – ₹ 300)	1,200.00
31st March, 2015	Less: Depreciation @ 20%	<u>(240.00)</u>
	Book value	960.00
31st March, 2016	Less: Depreciation @ 20%	<u>(192.00)</u>
	Book value	768.00
31st March, 2017	Less: Depreciation @ 20%	<u>(153.60)</u>
1st April, 2017	Book value	614.40
May, 2017	Add: Refund of grant	<u>300.00</u>
	Revised book value	<u>914.40</u>

Depreciation @ 20% on the revised book value amounting ₹ 914.40 lakhs is to be provided prospectively over the residual useful life of the asset i.e. years ended 31st March, 2015 and 31st March, 2016.

Illustration 4

Yogya Ltd. received a specific grant of ₹ 300 lakhs for acquiring the plant of ₹ 1,500 lakhs during 2010-11 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet. During 2016-2017, due to non-compliance of conditions laid down for the grant of ₹ 300 lakhs, the company had to refund the grant to the Government. Balance in the deferred income on that date was ₹ 210 lakhs and written down value of plant was ₹ 1,050 lakhs.

- What should be the treatment of the refund of the grant and the effect on cost of the fixed asset and the amount of depreciation to be charged during the year 2016-2017 in the Statement of Profit and Loss?
- What should be the treatment of the refund if grant was deducted from the cost of the plant during 2010-11?

Assume depreciation is charged on assets as per Straight Line Method.

Solution

As per para 21 of AS 12, amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

- (i) In this case the grant refunded is ₹ 300 lakhs and balance in deferred income is ₹ 210 lakhs, therefore, ₹ 90 lakhs shall be charged to the profit and loss account for the year 2016-2017. There will be no effect on the cost of the fixed asset and depreciation charge will be same as charged in the earlier years.
- (ii) As per para 21 of AS 12, the amount refundable in respect of grant which was related to specific fixed assets should be recorded by increasing the book value of the assets by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Therefore, in this case the book value of the plant shall be increased by ₹ 300 lakhs. The increased cost of ₹ 300 lakhs of the plant should be amortised over 7 years (residual life). Depreciation charged during the year 2016-2017 shall be $1200/10 + 300/7 = ₹ 162.86$ lakhs.

Reference: The students are advised to refer the full text of AS 12 "Accounting for Government Grants" (issued 1991).

UNIT 12 : AS:13 ACCOUNTING FOR INVESTMENTS

12.1 Introduction

This Accounting Standard came into effect for financial statements covering periods commenced on or after April 1, 1995. The standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the current investments (realizable in nature and intended to be held for not more than one year from the date of its acquisition) and long terms investments (other than current investments) distinctly in their financial statements. An investment property should be accounted for as long-term investments. The cost of investments should include all acquisition costs (including brokerage, fees and duties) and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

This Standard does not deal with:

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

12.2 Definition of the terms used in the Standard

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

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

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

12.3 Forms of Investments

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity. Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). For some investments, an active

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

12.4 Classification of Investments

A **current investment** is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. The intention to hold for not more than one year is to be judged at the time of purchase of investment.

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

12.5 Cost of Investments

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

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

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

12.6 Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value.

Any reduction in realisable value is debited to profit and loss account, however, if realisable value of investment is increased subsequently, the increase in value of current investment to the level of the cost is credited to the profit and loss account.

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

12.7 Investment Properties

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. *An investment property is accounted for in accordance with cost model as prescribed in AS 10, 'Property, Plant and Equipment'. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property..*

12.8 Disposal of Investments

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

12.9 Reclassification of Investments

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

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

12.10 Disclosure

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

- a. The accounting policies followed for valuation of investments.
- b. The amounts included in profit and loss statement for:
 - i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.
 - ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.
 - iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.
- c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.
- d. The aggregate amount of quoted and unquoted securities separately.
- e. Other disclosures as specifically required by the relevant statute governing the enterprise.

Illustration 1

An unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2017 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31st March, 2017?

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2017 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2017.

Illustration 2

X Ltd. on 1-1-2017 had made an investment of ₹ 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realizable value of all such investment on 31-3-2017 became ₹ 200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is permanent in nature. How will you recognize the reduction in financial statements for the year ended on 31-3-2017?

Solution

X Ltd. invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.2017 to 31.3.2017), AS 13 lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realizable value of all such investments on 31.3.2017 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

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

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

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

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

Illustration 3

Sabka Bank has classified its total investment on 31-3-2017 into three categories (a) held to maturity (b) available for sale (c) held for trading.

'Held to maturity' investments are carried at acquisition cost less amortised amount. 'Available for sale' investments are carried at marked to market. 'Held for trading' investments are valued at weekly intervals at market rates or as per the prices declared by FIMMDA. Net depreciation, if any, is charged to revenue and net appreciation, if any, is ignored. Comment whether the policy of the bank is in accordance with AS 13?

Solution

As per para 2(d) of AS 13 'Accounting for Investments', the accounting standard is not applicable to Bank, Insurance Company, Mutual Funds. In this case Sabka Bank is a bank, therefore, AS 13 does not apply to it. For banks, the RBI has issued guidelines for classification and valuation of its investment and Sabka Bank should comply with those RBI Guidelines/Norms. Therefore, though Sabka Bank has not followed the provisions of AS 13, yet it would not be said as non-compliance since, it is complying with the norms stipulated by the RBI.

Reference: The students are advised to refer the full text of AS 13 "Accounting for Investments" (issued 1993).

UNIT 13 : AS 14: ACCOUNTING FOR AMALGAMATIONS

13.1 Introduction

This standard has come into effect in respect of accounting periods commenced on or after 1.4.1995 and is mandatory in nature. AS 14 deals with the accounting to be made in the books of Transferee company in the case of amalgamation and the treatment of any resultant goodwill or reserve.

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

An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method.

The standard describes the disclosure requirements for both types of amalgamations in the first financial statements. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises. We will discuss the other amalgamation aspects in detail in the next paragraphs of this unit.

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

13.2 Definition of the terms used in the Standard

- **Amalgamation** means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies *and includes 'merger'*.
- **Transferor company** means the company which is amalgamated into another company.
- **Transferee company** means the company into which a transferor company is amalgamated.

13.3 Types of Amalgamations

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

13.4 Amalgamation in the Nature of Merger

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

1.138 Financial Reporting

- (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- (v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

13.5 Amalgamation in the Nature of Purchase

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

13.6 Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations.

- the pooling of interests method and
- the purchase method.

13.6.1 Pooling of interests Method

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

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

13.6.2 Purchase Method

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

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

identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

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

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

13.7 Treatment of Reserves of the Transferor Company on Amalgamation

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

Adjustments to reserves - Amalgamation in the Nature of Merger

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

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

Adjustments to reserves - Amalgamation in the Nature of Purchase

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

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

1.140 Financial Reporting

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

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

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

So the presentation will be as follows:

Notes to Accounts for "Reserves and Surplus"

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

13.8 Treatment of Goodwill Arising on Amalgamation

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

13.9 Disclosures

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

statements following the amalgamation:

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

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

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

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

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

13.10 Miscellaneous Illustrations

Illustration 1

A Ltd. take over B Ltd. on April 01, 2017 and discharges consideration for the business as follows:

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

Solution

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

1.142 Financial Reporting

Illustration 2

The following are the summarised Balance Sheets of Big Ltd. and Small Ltd. as at 31.3.2017:

(₹ in lakhs)

	Big Ltd. ₹	Small Ltd. ₹		Big Ltd. ₹	Small Ltd. ₹
Share Capital	40.0	15.0	Sundry Assets (including cost of shares)	56.0	20.0
Profit & Loss A/c	7.5	--	Goodwill	4.0	5.0
Trade Payables	<u>12.5</u>	<u>12.5</u>	Profit and Loss A/c	<u>--</u>	<u>2.5</u>
	<u>60.0</u>	<u>27.5</u>		<u>60.0</u>	<u>27.5</u>

Additional Information:

- The two companies agree to amalgamate and form a new company, Medium Ltd.
- Big Ltd. holds 10,000 shares in Small Ltd. acquired at a cost of ₹ 2,50,000 and Small Ltd. holds 5,000 shares in Big Ltd. acquired at a cost of ₹ 7,00,000.
- The shares of Big Ltd. are of ₹ 100 and are fully paid and the shares of Small Ltd. are of ₹ 50 each on which ₹ 30 has been paid-up.
- It is agreed that the goodwill of Big Ltd. would be valued at ₹ 1,50,000 and that of Small Ltd. at ₹ 2,50,000.
- The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuation decided as given in (iv).
- The new shares are to be of a nominal value of ₹ 50 each credited as ₹ 25 paid.

You are required to:

- Prepare the Balance Sheet of Medium Ltd., as at 31st March, 2017 after giving effect to the above transactions; and
- Prepare a statement showing the shareholdings in the new company attributable to the shareholders of the merged companies.

Solution

- Balance Sheet of Medium Ltd. as on 31st March, 2017

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
Share Capital		45,50,000
(2) Current Liabilities		
Trade Payable		25,00,000
Total		70,50,000

II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets	1	66,50,000
Intangible assets	2	4,00,000
Total		70,50,000

Notes to Accounts:

	(₹)
1. Tangible Assets	
Sundry Assets (₹53,50,000 + ₹13,00,000)	66,50,000
2. Intangible Assets	
Goodwill (₹1,50,000 + ₹2,50,000)	4,00,000

(ii) Statement of Shareholding in Medium Ltd.

	<i>Big Ltd.</i> ₹	<i>Small Ltd.</i> ₹
Total value of Assets	44,20,513	8,52,564
Less: Pertaining to shares held by the other company	<u>(5,52,564)</u>	<u>(1,70,513)</u>
	<u>38,67,949</u>	<u>6,82,051</u>
Rounded off to	38,67,950	6,82,050
Shares of new company (at ₹ 25 per share)	<u>1,54,718</u>	<u>27,282</u>
Total purchase consideration to be paid to Big Ltd and Small Ltd. (₹ 38,67,950 + ₹ 6,82,050)		₹ 45,50,000
Number of shares in Big Ltd. (40,00,000/100)		40,000 shares
Number of shares in Small Ltd. (15,00,000/30)		50,000 shares
Holding of Small Ltd. in Big Ltd. (5,000/40,000)		1/8
Holding of Big Ltd. in Small Ltd. (10,000/50,000)		1/5
Number of shares held by outsiders in Big Ltd. (40,000 – 5,000) =		35,000
Number of shares held by outsiders in Small Ltd. (50,000 – 10,000)		40,000

Workings Note:**Calculation of Book Value of Shares**

	<i>Big Ltd</i> ₹	<i>Small Ltd.</i> ₹
Goodwill	1,50,000	2,50,000
Sundry Assets other than shares in other company		

1.144 Financial Reporting

₹ (56,00,000 – 2,50,000)	53,50,000	
₹ (20,00,000 – 7,00,000)		<u>13,00,000</u>
	55,00,000	15,50,000
Less: Trade payables	<u>(12,50,000)</u>	<u>(12,50,000)</u>
	<u>42,50,000</u>	<u>3,00,000</u>

If "x" is the Book Value of Assets of Big Ltd and "y" of Small Ltd.

$$x = 42,50,000 + \frac{1}{5}y$$

$$y = 3,00,000 + \frac{1}{8}x$$

$$x = 42,50,000 + \frac{1}{5}(3,00,000 + \frac{1}{8}x)$$

$$= 42,50,000 + 60,000 + \frac{1}{40}x$$

$$\frac{39}{40}x = 43,10,000$$

$$x = 43,10,000 \times \frac{40}{39}$$

$$x = 44,20,513 \text{ (approx.)}$$

$$y = 3,00,000 + \frac{1}{8}(44,20,513)$$

$$= 3,00,000 + 5,52,564$$

$$= ₹ 8,52,564 \text{ (approx.)}$$

$$\text{Book Value of one share of Big Ltd.} = \frac{44,20,513}{40,000} = ₹ 110.513 \text{ (approx.)}$$

$$\text{Book Value of one share of Small Ltd.} = \frac{8,52,564}{50,000} = ₹ 17.05 \text{ (approx.)}$$

Illustration 3

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2017. A new company C Ltd. was formed to take over the business of the existing companies. The summarised Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2017 are given below:

Liabilities	(₹ in lakhs)		Assets	(₹ in lakhs)	
	A Ltd.	B Ltd.		A Ltd.	B Ltd.
Share Capital			Fixed Assets		

Equity Shares of ₹ 100 each	800	750	Land and Building	550	400
12% Preference shares of ₹ 100 each	300	200	Plant and Machinery	350	250
Reserves and Surplus			Investments	150	50
Revaluation Reserve	150	100	Current Assets, Loans and Advances		
General Reserve	170	150	Inventory	350	250
Investment Allowance Reserve	50	50	Trade Receivables	300	350
Profit and Loss Account	50	30	Cash and Bank	300	200
Secured Loans					
10% Debentures (₹ 100 each)	60	30			
Current Liabilities and provisions					
Trade Payables	<u>420</u>	<u>190</u>			
	<u>2,000</u>	<u>1,500</u>		<u>2,000</u>	<u>1,500</u>

Additional Information:

- (1) 10% Debenture holders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of ₹ 100 each so as to maintain the same amount of interest.
- (2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of ₹ 150 per share (face value of ₹ 100).
- (3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ ₹ 30 each, having a face value of ₹ 10 per share.
- (4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 2017 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Solution

**Balance Sheet of C Ltd.
as at 1st April, 2017**

Particulars	Note No.	(₹ in lakhs)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,200
(b) Reserves and Surplus	2	1,650
(2) Non-Current Liabilities		
Long-term borrowings	3	60
(3) Current Liabilities		

1.146 Financial Reporting

Trade payables	8	610
Total		3,520
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
i. Tangible assets	4	1,550
ii. Intangible assets	5	20
(b) Non-current investments	6	200
(2) Current assets		
(a) Inventory		600
(b) Trade receivables	7	650
(c) Cash and cash equivalents		500
Total		3,520

Notes to Accounts

	(₹ in lakhs)	(₹ in lakhs)
1. Share Capital		
Equity share capital (W.N.2)		
70,00,000 Equity shares of ₹ 10 each	700	
5,00,000 Preference shares of ₹ 100 each	500	
(all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)		1,200
2. Reserves and surplus		
Securities Premium Account	1,650	
Investment Allowance Reserve	100	
Amalgamation Adjustment Reserve	(100)	1,650
3. Long-term borrowings		
15% Debentures		60
4. Tangible assets		
Land and Building	950	
Plant and Machinery	600	1,550
5. Intangible assets		
Goodwill [W.N. 2]		20
6. Non-current Investments		
Investments		200
7. Trade receivables		650
8. Trade payables		610

Working Notes:

		(₹ in lakhs)	
		A Ltd.	B Ltd.
(1)	Computation of Purchase consideration		
	(a) Preference shareholders:		
	$\left(\frac{3,00,00,000}{100} \text{ i.e. } 3,00,000 \text{ shares}\right) \times ₹ 150 \text{ each}$	450	
	$\left(\frac{2,00,00,000}{100} \text{ i.e. } 2,00,000 \text{ shares}\right) \times ₹ 150 \text{ each}$		300
	(b) Equity shareholders:		
	$\left(\frac{8,00,00,000 \times 5}{100} \text{ i.e. } 40,00,000 \text{ shares}\right) \times ₹ 30 \text{ each}$	1,200	
	$\left(\frac{7,50,00,000 \times 4}{100} \text{ i.e. } 30,00,000 \text{ shares}\right) \times ₹ 30 \text{ each}$	—	<u>900</u>
	Amount of Purchase Consideration	<u>1,650</u>	<u>1,200</u>
(2)	Net Assets Taken Over		
	Assets taken over:		
	Land and Building	550	400
	Plant and Machinery	350	250
	Investments	150	50
	Inventory	350	250
	Trade receivables	300	350
	Cash and bank	<u>300</u>	<u>200</u>
		2,000	1,500
	Less: Liabilities taken over:		
	Debentures	40	20
	Trade payables	<u>420</u>	<u>190</u>
		<u>460</u>	<u>210</u>
	Net assets taken over	1,540	1,290
	Purchase consideration	<u>1,650</u>	1,200
	Goodwill	<u>110</u>	—
	Capital reserve		<u>90</u>

Reference: The students are advised to refer the full text of AS 14 "Accounting for Amalgamations" (issued 1994).

UNIT 14 : AS 15: EMPLOYEE BENEFITS

14.1 Introduction

The revised Accounting Standard 15 - 'Employee Benefits' (AS 15), generally deals with all forms of employee benefits all forms of consideration given by an enterprise in exchange for services rendered by employees (other than inventory compensation for which a separate guidance note is promulgated), many of which were not dealt with by pre-revised AS 15. The Standard addresses only the accounting of employee benefits by employers. The Standard makes four things very clear at the outset:

- (i) the Standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff;
- (ii) employee benefits can be paid in cash or in kind;
- (iii) employee benefits include benefits provided to employees and their dependents (spouses, children and others); and
- (iv) payment can be made directly to employees, their dependent or to any other party (e.g., insurance companies, trust etc.).

Employee benefits include:

- (a) Short-term employee benefits (e.g. wages, salaries, paid annual leave and sick leave, profit sharing bonuses etc. (payable within 12 months of the year-end) and non-monetary benefits for current employees;
- (b) Post-employment benefits (e.g., gratuity, pension, provident fund, post-employment medical care etc.);
- (c) long-term employee benefits (e.g., long-service leave, long-term disability benefits, bonuses not wholly payable within 12 months of the year end etc.); and
- (d) termination benefits (e.g. VRS payments)

The Standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.

14.2 Applicability

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. This standard is applicable predominantly for Level 1 enterprises, and applied to other entities with certain relaxations as mentioned in Appendix III at the end of the Study Material (Volume II).

14.3 Meaning of the term "Employee Benefits"

The term employee is not defined under the standard AS 15 does not define who is an 'employee', but states in that "an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees

include directors and other management personnel". This suggests that the intention was for the term 'employee' to apply more widely than simply to persons with a contract of employment as 'casual' and 'temporary' staff may frequently not have such contracts.

The following indicators may suggest an employee relationship may be more likely to exist, and may help in making individual judgements:

- ◆ A contract of employment exists;
- ◆ Individuals are considered employees for legal/tax/social security purposes;
- ◆ There is a large amount of oversight and direction by the employer and necessary tools, equipment and materials are provided by the employer;
- ◆ Services are performed at a location specified by the employer;

Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:

- ◆ Has no other clients;
- ◆ Has served the employer for a long period;
- ◆ Faces little or no financial risk;
- ◆ Requires the explicit permissions of the employer to concurrently undertake additional employment elsewhere.

14.4 Short-term Employee Benefits

Short-term employee benefits (other than termination benefits) are payable within twelve months after the end of the period in which the service is rendered. Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost. Short-term employee benefits are broadly classified into four categories:

- (i) regular period benefits (e.g., wages, salaries);
- (ii) short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);
- (iii) profit sharing and bonuses payable within twelve months after the end of the period in which employee render the related services and
- (iv) non-monetary benefits (e.g., medical care, housing, cars etc.)

The Standard lays down some general recognition criteria for all short-term employee benefits. There are further requirements in respect of short-term compensated absences and profit sharing and bonus plans. The general criteria say that an enterprise should recognize as an expense (unless another accounting standard permits a different treatment) the undiscounted amount of all short-term employee benefits attributable to services that been already rendered in the period and any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate.

The expected cost of accumulating compensated absences should be recognized when employees render the service that increase their entitlement to future compensated absences. 'An enterprise should measure the expected cost of accumulating compensated absences as the *additional amount* that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'. No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

Non-accumulating compensated absences (e.g., maternity leave) do not carry forward and are not directly linked to the services rendered by employees in the past. Therefore, an enterprise recognizes no liability or expense until the time of the absence. In other words, the cost of non-accumulating absences should be recognized as and when they arise.

Recognition of expenses for profit sharing and bonus plans would depend on fulfillment of conditions mentioned the Standard. The conditions are:

- (a) Enterprise has a present obligation to make such payments as a result of past events; and
- (b) Reliable estimate of the obligation can be made.

The second condition can be satisfied only when the profit sharing and bonus plans contained a formula for determining the amount of benefit. The enterprise should recognize the expected cost of profit sharing and bonus payments in the financial statements.

14.5 Post Employment Benefits: Defined Contribution vs Defined Benefits

The accounting treatment and disclosures required for a post-employment benefit plan depend upon whether it is a defined contribution or a defined benefit plan. In addition to addressing defined contribution and defined benefit plans generally, the Standard also gives guidance as to how its requirements should be applied to insured benefits, multi-employment benefit plans. **Defined contribution plans** are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. In defined benefits plans, the actuarial and investment risk fall on the employer.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

14.6 Is the Gratuity Scheme a Defined Contribution or Defined Benefit Scheme?

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either:

- (a) pay the employee benefits directly when they fall due;
- (b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

On the asset side, a question arises as to whether the funds under the scheme as certified by LIC would be treated as plan assets or reimbursement rights. The distinction is important (though both are measured on fair valuation basis) because plan assets are reduced from the defined benefit obligation and the net amount is disclosed in the balance sheet, whereas, in the case of reimbursement rights, the defined benefit obligation and the reimbursement rights are shown separately as liability and asset on the balance sheet. This would have the impact of making the balance sheet heavy both on the asset side as well as the liabilities side.

14.7 Other Long Term Employee Benefits

Other long-term employee benefits include, for example:

- (a) long-term compensated absences such as long-service or sabbatical leave;
- (b) jubilee or other long-service benefits;
- (c) long-term disability benefits;
- (d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and
- (e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

14.8 Termination Benefits

Termination Benefits are employee benefits payable as a result of either an enterprise's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept voluntary redundancy in exchange for those benefits (e.g., payments under VRS). Termination benefits are recognized by an enterprise as a liability and an expense only when the enterprise has

- (i) a detailed formal plan for the termination which is duly approved, and
- (ii) a reliable estimate can be made of the amount of the obligation.

Where the termination benefits fall due within twelve months after the balance sheet date, an *undiscounted* amount of such benefits should be recognized as liability in the balance sheet with a corresponding charge to Profit & Loss Account. However, when the termination benefits

fall due more than twelve months after the balance sheet date, such benefits should be discounted using an appropriate discount rate. Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees expected to accept the offer. Where there is uncertainty with regard to the number of employees who will accept an offer of voluntary redundancy, a contingent liability exists and should be so disclosed as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

14.9 Accounting Treatment

In the Balance Sheet of the enterprise, 'the amount recognized as a defined benefit liability should be the net total of the following amounts:

- (a) the present value of the defined benefit obligation at the balance sheet date;
- (b) *minus* any past service cost not yet recognized;
- (c) *minus* the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.'

In case where fair value of plan assets is high, it may so happen that the net amount under defined benefit liability turns negative (giving rise to net assets). AS 15 states that the enterprise, in such a situation, should measure the resulting asset at the lower of:

- (i) the amount so determined; and
- (ii) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The recognition of expenses relating to defined benefits in the Profit and Loss Account is stated in Para 61 of the Standard. The Standard identifies *seven* components of defined employee benefit costs:

- (a) current service cost;
- (b) interest cost;
- (c) the expected return on any plan assets (and any reimbursement rights);
- (d) actuarial gains and losses (to the extent they are recognized);
- (e) past service cost (to the extent they are recognized);
- (f) the effect of any curtailments or settlements; and
- (g) the extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(ii) of the Standard.

The item (f) above needs explanation. A settlement occurs when an employer enters into a transaction that eliminates all further legal or constructive obligations for part or whole of the benefits provided under a defined benefit plan. For example, the commuted portion of pension. A curtailment occurs when an employer either commits to reduce the number of employees covered by a plan or reduces the benefits under a plan. The gains or losses on the settlement or curtailment of a defined benefit plan should be recognized when the settlement or curtailment occurs.

14.10 Disclosures

Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists.

As required by AS 29, "Provisions, Contingent Liabilities and Contingent Assets" an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

As required by AS 5, "Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies" an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period.

Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

Where required by AS 18, "Related Party Disclosures", an enterprise discloses information about termination benefits for key management personnel.

When drafting AS 15 (revised), the standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallized at this stage. Revised AS 15 (2005) requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

As per the transitional provision of revised AS 15, as regards VRS as paid upto 31 March, 2009, there is a choice to defer it over pay-back period, subject to prohibition on carry forward to periods commencing on or after 1 April, 2010.

14.11 Actuarial Assumptions

The actuarial assumptions should be unbiased and mutually compatible. They are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. They should be neither imprudent nor excessively conservative, and should reflect the economic relationships between factors such as inflation, rates of salary increase, return on plan assets and discount rates.

AS 15 explains that actuarial assumptions comprise:

- (a) demographic assumptions about the future characteristics of current and former employees (and their dependents) who are eligible for benefits. Demographic assumptions deal with matters such as:
 - (i) mortality, both during and after employment;
 - (ii) rates of employee turnover, disability and early retirement;
 - (iii) the proportion of plan members with dependents who will be eligible for benefits;
 - (iv) claim rates under medical plans; and

1.154 Financial Reporting

- (b) financial assumptions, dealing with items such as:
- (i) the discount rate
 - (ii) future salary and benefit levels
 - (iii) in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments and
 - (iv) the expected rate of return on plan assets.

Financial assumptions: Financial assumptions should be based on market expectation at the balance sheet date for the period over which the post-employment benefit obligations will be settled. Discount rates and other financial assumptions should not be inflation-adjusted unless such measures are more reliable (eg where benefits are index-linked)

14.12 Actuarial Gains and Losses

Actuarial gains and losses comprise:

- experience adjustments (the effects of difference between the previous actuarial assumptions and what has actually occurred); and
- the effects of changes in actuarial assumptions.

Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. While this is the general principle, as per AS 15, in case an enterprise adopts the option to defer the recognition of any subsequent actuarial gains is limited to excess of cumulative (unrecognized gains) over the unrecognized portion of increase in transitional liability.

Illustration 1

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards.

Solution

According to AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 2

As on 1st April, 2016 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 2016 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 2017 the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Actuarial losses on the obligations for the year 2016-2017 were ₹ 600.

On 1st April, 2016, the company made the following estimates, based on its market studies, understanding and prevailing prices.

	%
Interest & dividend income, after tax payable by the fund	9.25
Realised and unrealised gains on plan assets (after tax)	2.00
Fund administrative costs	<u>(1.00)</u>
Expected Rate of Return	<u>10.25</u>

You are required to find the expected and actual returns on plan assets.

Solution

Computation of Expected and Actual Returns on Plan Assets

	₹
Return on ₹ 1,00,000 held for 12 months at 10.25%	10,250
Return on ₹ 30,000 (49,000-19,000) held for six months at 5% (equivalent to 10.25% annually, compounded every six months)	<u>1,500</u>
Expected return on plan assets for 2016-2017	<u>11,750</u>
Fair value of plan assets as on 31 March, 2017	1,50,000
Less: Fair value of plan assets as on 1 April, 2016	1,00,000
Contributions received	<u>49,000</u>
	1,000
Add: Benefits paid	<u>19,000</u>
Actual return on plan assets	<u>20,000</u>

Alternatively, the above question may be solved without giving compound effect to rate of return.

Illustration 3

Rock Star Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. If the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Rock Star Ltd. estimates the share of unamortized service cost that relates to the part of the obligation at ₹ 18 (10% of ₹ 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

- Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.
- The fair value of plan assets on the date is estimated at ₹ 5,100.

1.156 Financial Reporting

(c) The unamortized past service cost is ₹ 180.

(d) Curtailment reduces the obligation by ₹ 600, which is 10% of the gross obligation.

Solution

Gain from curtailment is estimated as under:

	₹
Reduction in gross obligation	600
Less: Proportion of unamortised past service cost	(18)
Gain from curtailment	<u>582</u>

The liability to be recognised after curtailment in the balance sheet is estimated as under:

	₹
Reduced gross obligation (90% of ₹ 6,000)	5,400
Less: Fair value of plan assets	(5,100)
	300
Less: Unamortised past service cost (90% of ₹ 180)	(162)
Liability to be recognised in the balance sheet	<u>138</u>

Illustration 4

An employee Roshan has joined a company XYZ Ltd. in the year 2016. The annual emoluments of Roshan as decided is ₹ 14,90,210. The company also has a policy of giving a lump sum payment of 25% of the last drawn annual salary of the employee for each completed year of service if the employee retires after completing minimum 5 years of service. The salary of the Roshan is expected to grow @ 10% per annum.

The company has inducted Roshan in the beginning of the year and it is expected that he will complete the minimum five year term before retiring.

What is the amount the company should charge in its Profit and Loss account every year as cost for the Defined Benefit obligation? Also calculate the current service cost and the interest cost to be charged per year assuming a discount rate of 8%.

(P.V factor for 8% - 0.735, 0.794, 0.857, 0.926, 1)

Solution

Calculation of Defined Benefit Obligation

$$\begin{aligned}\text{Expected last drawn salary} &= ₹ 14,90,210 \times 110\% \times 110\% \times 110\% \times 110\% \times 110\% \\ &= ₹ 24,00,000\end{aligned}$$

$$\text{Defined Benefit Obligation (DBO)} = ₹ 24,00,000 \times 25\% \times 5 = ₹ 30,00,000$$

Amount of ₹ 6,00,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost

Year	Equal apportioned amount of DBO [i.e. ₹ 30,00,000/5 years]	Discounting @ 8% PV factor	Current service cost (Present Value)
a	b	c	d = b x c
1	6,00,000	0.735 (4 Years)	4,41,000
2	6,00,000	0.794 (3 Years)	4,76,400
3	6,00,000	0.857 (2 Years)	5,14,200
4	6,00,000	0.926 (1 Year)	5,55,600
5	6,00,000	1 (0 Year)	6,00,000

Calculation of Interest Cost to be charged per year

Year	Opening balance	Interest cost	Current service cost	Closing balance
a	b	c = b x 8%	d	e = b + c + d
1	0	0	4,41,000	4,41,000
2	4,41,000	35,280	4,76,400	9,52,680
3	9,52,680	76,214	5,14,200	15,43,094
4	15,43,094	1,23,447	5,55,600	22,22,141
5	22,22,141	1,77,859*	6,00,000	30,00,000

*Due to approximations used in calculation, this figure is adjusted accordingly.

Reference: The students are advised to refer the full text of AS 15 “Employee Benefits” (Revised 2005).

UNIT15 : AS 16: BORROWING COSTS

15.1 Introduction

The standard prescribes the accounting treatment for borrowing costs (i.e. interest and other costs) incurred by an enterprise in connection with the borrowing of funds. Borrowing costs are required to be capitalized as part of a qualifying asset (an asset that takes a substantial period of time to get ready for its intended use), if it is directly attributable towards its acquisition, construction or production. Upon such capitalization, the carrying amount of assets should be assessed as to whether it is greater than its recoverable amount or net realizable value and adjustments are required to be made in accordance with other standards. The amount of borrowing costs eligible for capitalization should be determined in accordance with AS 16 and other borrowing costs (not eligible for capitalization) should be recognized as expenses in the period in which they are incurred. This Standard came into effect in respect of accounting periods commenced on or after 1-4-2000 and is mandatory in nature. This Standard does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

15.2 Borrowing Costs

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

Borrowing costs may include:

- a. Interest and commitment charges on bank borrowings and other short-term and long-term borrowings;
- b. Amortisation of any discounts or premiums relating to borrowings;
- c. Amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
- d. Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and
- e. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

An enterprise should not apply AS 16 to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis over a short period of time, since such inventories are not qualifying assets.

15.3 Qualifying Asset

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

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.

15.4 Substantial Period

The issue as to what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale should be considered.

Depending on the circumstances, any of the following may be qualifying assets.

- inventories that take a substantial amount of time to bring them to a saleable condition For example, liquor is often required to be kept in store for more than twelve months for maturing;
- investments properties;
- manufacturing plants; and
- power generation facilities.

The following are not qualifying assets:

- assets that are ready for their intended use or sale when acquired; and
- inventories that are routinely manufactured, or otherwise produced in large quantities on a repetitive basis, over a short period of time.

15.5 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.

15.6 Exchange Differences on Foreign Currency Borrowings

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, 'The Effect of Changes in Foreign Exchange Rates'. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

Example

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 2X16, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 2X16, the exchange rate between the currencies was ₹ 45 per USD. The exchange rate, as at March 31, 2X17, is ₹ 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 2X16. Calculate the borrowing cost to be capitalized as per AS 16.

Solution

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

- (i) Interest for the period = USD 10,000 x 5% x ₹ 48/USD = ₹ 24,000
- (ii) Increase in the liability towards the principal amount = USD 10,000 x (48-45) = ₹ 30,000
- (iii) Interest that would have resulted if the loan was taken in Indian currency
= USD 10,000 x 45 x 11% = ₹ 49,500
- (iv) Difference between interest on local currency borrowing and foreign currency borrowing
= ₹ 49,500 – ₹ 24,000 = ₹ 25,500

Therefore, out of ₹ 30,000 increase in the liability towards principal amount, only ₹ 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 49,500 being the aggregate of interest of ₹ 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 25,500.

Thus, ₹ 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of ₹ 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings (i.e., ₹ 34,500 (₹ 58,500 – ₹ 24,000)) is more than the exchange difference of ₹ 30,000. Therefore, in such a case, the total borrowing cost would be ₹ 54,000 (₹ 24,000 + ₹ 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11 'The Effects of Changes in Foreign Exchange Rates'.

15.7 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.

15.8 Commencement of Capitalisation

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following these 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.

15.9 Suspension of Capitalisation

Capitalisation of borrowing costs should generally continue as long as the three conditions listed above are met. If, however, the enterprise suspends activities related to development for an extended period, capitalisation of borrowing costs should also cease unit such time as activities

are resumed.

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.

15.10 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.

15.11 Disclosure

The financial statements should disclose:

- The accounting policy adopted for borrowing costs; and
- The amount of borrowing costs capitalised during the period.

15.12 Illustrations

Illustration 1

Particulars	Amount (₹)
<i>Expenditure incurred till 31-03-2016</i>	7,00,000
<i>Interest cost capitalized for the financial year 2015-2016</i>	30,000
<i>Amount borrowed till 31-03-2016 @ 15%</i>	4,00,000
<i>Amount transferred to construction during 2016-2017</i>	2,00,000
<i>Cash payment during 2016-2017 out of the above</i>	1,00,000
<i>Progress payment received</i>	5,00,000
<i>New borrowing during 2016-2017 @ 15%</i>	3,00,000

Calculate the amount of borrowing to be capitalized.

Solution

Total Borrowing Cost = 7,00,000 X 0.15 = ₹ 1,05,000

Particulars	Amount (₹)
Expenditure incurred including previously capitalized borrowing cost	7,30,000
Cash payment during 2016-2017 out of amount transferred	1,00,000
Remaining amount transferred during 2016-2017	<u>1,00,000</u>

	9,30,000
Less: Progress payment received and recognized (certified)	<u>5,00,000</u>
Uncertified construction cost (not yet recognized)	<u>4,30,000</u>

Total Money borrowed including previously capitalized interest cost = ₹ 7,30,000

Borrowing cost to be capitalized = $4,30,000/7,30,000 \times 1,05,000 = ₹ 61,849.32$

Illustration 2

PRM Ltd. obtained a loan from a bank for ₹ 50 lakhs on 30-04-2016. It was utilized as follows:

Particulars	Amount (₹ in lakhs)
Construction of a shed	50
Purchase of a machinery	40
Working Capital	20
Advance for purchase of truck	10

Construction of shed was completed in March 2017. The machinery was installed on the same date. Delivery truck was not received. Total interest charged by the bank for the year ending 31-03-2017 was ₹ 18 lakhs. Show the treatment of interest.

Solution

Qualifying Asset as per AS 16 = ₹ 50 lakhs (construction of a shed)

Borrowing cost to be capitalized = $18 \times 50/120 = ₹ 7.5$ lakhs

Interest to be debited to Profit or Loss account = ₹ (18 – 7.5) lakhs

= ₹ 10.5 lakhs

Illustration 3

The company has obtained Institutional Term Loan of ₹ 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 2017 amounted to ₹ 406 lakhs, ₹ 58 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of ₹ 52.20 lakhs incurred during 2016-2017 on the entire Institutional Term Loan of ₹ 580 lakhs.

Solution

As per para 6 of AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred. Borrowing costs should be expensed except where they are directly attributable to acquisition, construction or production of qualifying asset.

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

1.164 Financial Reporting

The treatment for total interest amount of ₹ 52.20 lakhs can be given as:

<i>Purpose</i>	<i>Nature</i>	<i>Interest to be capitalised</i>	<i>Interest to be charged to profit and loss account</i>
		₹ in lakhs	₹ in lakhs
Modernisation and renovation of plant and machinery	Qualifying asset	$^{**}52.20 \times \frac{406}{580} = 36.54$	
Advance to supplies for additional assets	Qualifying asset	$^{**}52.20 \times \frac{58}{580} = 5.22$	
Working Capital	Not a qualifying asset		$52.20 \times \frac{116}{580} = 10.44$
		<u>41.76</u>	<u>10.44</u>

* A substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case.

** It is assumed in the above solution that the modernization and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assets. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assets on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, ₹ 52.20 lakhs will be recognized as expense in the profit and loss account for year ended 31st March, 2017.

Illustration 4

The notes to accounts of X Ltd. for the year 2016-2017 include the following:

"Interest on bridge loan from banks and Financial Institutions and on Debentures specifically obtained for the Company's Fertiliser Project amounting to ₹ 1,80,80,000 has been capitalized during the year, which includes approximately ₹ 1,70,33,465 capitalised in respect of the utilization of loan and debenture money for the said purpose." Is the treatment correct? Briefly comment.

Solution

The treatment done by the company is not in accordance with AS 16 'Borrowing Costs'. As per para 10 of AS 16, to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period. Hence, the capitalisation of borrowing costs should be restricted to the actual amount of interest expenditure i.e. ₹ 1,70,33,465. Thus, there is an excess capitalisation of ₹ 10,46,535. This has resulted in overstatement of profits by ₹ 10,46,535 and amount of fixed assets has also gone up by this amount.

Illustration 5

XYZ Ltd., has undertaken a project for expansion of capacity as per the following details:

	Plan ₹	Actual ₹
April, 2017	2,00,000	2,00,000
May, 2017	2,00,000	3,00,000
June, 2017	10,00,000	–
July, 2017	1,00,000	–
August, 2017	2,00,000	1,00,000
September, 2017	5,00,000	7,00,000

The company pays to its bankers at the rate of 12% p.a., interest being debited on a monthly basis. During the half year company had ₹ 10 lakhs overdraft upto 31st July, surplus cash in August and again overdraft of over ₹ 10 lakhs from 1.9.2017. The company had a strike during June and hence could not continue the work during June. Work was again commenced on 1st July and all the works were completed on 30th September. Assume that expenditure were incurred on 1st day of each month. Calculate:

- (i) Interest to be capitalised.
- (ii) Give reasons wherever necessary.

Assume:

- (a) Overdraft will be less, if there is no capital expenditure.
- (b) The Board of Directors based on facts and circumstances of the case has decided that any capital expenditure taking more than 3 months as substantial period of time.

Solution**XYZ Ltd.**

Month	Actual Expenditure ₹	Interest Capitalised ₹	Cumulative Amount ₹	
April, 2017	2,00,000	2,000	2,02,000	
May, 2017	3,00,000	5,020	5,07,020	
June, 2017	–	5,070	5,12,090	Note 2
July, 2017	–	5,120	5,17,210	
August, 2017	1,00,000	–	6,17,210	Note 3
September, 2017	<u>7,00,000</u>	<u>10,000</u>	<u>13,27,210</u>	Note 4
	<u>13,00,000</u>	<u>27,210</u>	<u>13,27,210</u>	

Note:

1. There would not have been overdraft, if there is no capital expenditure. Hence, it is a case of specific borrowing as per AS 16 on Borrowing Costs.
2. The company had a strike in June and hence could not continue the work during June. As per para 14 (c) of AS 16, the activities that are necessary to prepare the asset for its intended use or sale are in progress. The strike is not during extended period. Thus during strike period, interest need to be capitalised.
3. During August, the company did not incur any interest as there was surplus cash in August. Therefore, no amount should be capitalised during August as per para 14(b) of AS 16.
4. During September, it has been taken that actual overdraft is ₹ 10 lakhs only. Hence, only ₹ 10,000 interest has been capitalised even though actual expenditure exceeds ₹ 10 lakhs.

Alternatively, interest may be charged on total amount of (₹ 6,17,210 + ₹ 7,00,000 = ₹ 13,17,210) for the month of September, 2017 as it is given in the question that overdraft was over ₹ 10 lakhs from 1.9.2017 and not exactly ₹ 10 lakhs. In that case, interest amount ₹ 13,172 will be capitalised for the month of September.

Illustration 6

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2016-2017. 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, 2017, since the said project was not complete, the directors of Take Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment.

Solution

As per para 9 of AS 13 "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per 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, 2017.

Reference: The students are advised to refer the full text of AS 16 "Borrowing Costs" (issued 2000).

UNIT 16 : AS 17: SEGMENT REPORTING

16.1 Introduction

This Standard came into effect in respect of accounting periods commenced on or after 1.4.2001 and is mandatory in nature, from that date, in respect of the following:

- (i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised 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.

This standard establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The information is expected to help users of financial statements, to better understand the performance and assess the risks and returns of the enterprise and make more informed judgements about the enterprise as a whole. The standard is more relevant for assessing risks and returns of a diversified or multi-locational enterprise which may not be determinable from the aggregated data.

16.2 Objective

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

- (a) Better understand the performance of the enterprise;
- (b) Better assess the risks and returns of the enterprise; and
- (c) Make more informed judgements about the enterprise as a whole.

16.3 Scope

An enterprise should comply with the requirements of this Standard fully and not selectively. If a single financial report contains both consolidated financial statements and the separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements. In the context of reporting of segment information in consolidated financial statements, the references in this Statement to any financial statement items should construed to be the relevant item as appearing in the consolidated financial statements.

16.4 Definition of the terms used in the Accounting Standard

A **business segment** is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

- a. The nature of the products or services.
- b. The nature of the production processes.
- c. The type or class of customers for the products or services;.
- d. The methods used to distribute the products or provide the services and
- e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

A **geographical segment** is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

- a. Similarity of economic and political conditions.
- b. Relationships between operations in different geographical areas.
- c. Proximity of operations.
- d. Special risks associated with operations in a particular area.
- e. Exchange control regulations and
- f. The underlying currency risks.

A single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.

The risks and returns of an enterprise are influenced both by the geographical location of its operations and also by the location of its customers. The definition allows geographical segments to be based on either:

- a. The location of production or service facilities and other assets of an enterprise; or
- b. The location of its customers.

A **reportable segment** is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by this Statement.

The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

Segment revenue is the aggregate of

- (i) The portion of enterprise revenue that is directly attributable to a segment,
- (ii) The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment, and
- (iii) Revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and
- c. Gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Segment expense is the aggregate of

- (i) The expense resulting from the operating activities of a segment that is directly attributable to the segment, and
- (ii) The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment,
- (iii) Including expense relating to transactions with other segments of the enterprise.

Segment expense does not include:

- a. Extraordinary items as defined in AS 5.
- b. Interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature.
- c. Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature.
- d. Income tax expense; and
- e. General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

1.170 Financial Reporting

If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include:

- income tax assets;
- assets used for general enterprise or head-office purposes.

Segment assets are determined after deducting related allowances/provisions that are reported as direct offsets in the balance sheet of the enterprise.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Liabilities that relate jointly to two or more segment should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

Examples of segment liabilities include trade and other payables, accrued liabilities, customer advances, product warranty provisions, and other claims relating to the provision of goods and services.

Segment liabilities do not include:

- income tax liabilities;
- borrowings and other liabilities that are incurred for financing rather than operating purposes.

16.5 Treatment of Interest for determining Segment Expense

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories as per paragraph below.

In case interest is included as a part of the cost of inventories where it is so required as per AS 16, read with AS 2, Valuation of Inventories, and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest should be disclosed by way of a note to the segment result.

16.6 Allocation

An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial

reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segments.

In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in this Statement. Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment. While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

16.7 Primary and Secondary Segment Reporting Formats

The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments. Internal organisation and management structure of an enterprise and its system of internal financial reporting to the board of directors and the chief executive officer should normally be the basis for identifying the predominant source and nature of risks and differing rates of return facing the enterprise and, therefore, for determining which reporting format is primary and which is secondary, except as provided paragraphs below:

- a. If risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates, as evidenced by a 'matrix approach', then the enterprise should use business segments as its primary segment reporting format and geographical segments as its secondary reporting format; and
- b. If internal organisational and management structure of an enterprise are based neither on individual products or services or groups of related products/services nor on geographical areas, it should be determined whether the risks and returns of the enterprise are related more to the products and services it produces or to the geographical areas in which it operates and accordingly, choose segments.

16.8 Matrix Presentation

A 'matrix presentation' both business segments and geographical segments as primary segment reporting formats with full segment disclosures on each basis will often provide useful

information if risks and returns of an enterprise are strongly affected both by differences in the products and services it produces and by differences in the geographical areas in which it operates. This Statement does not require, but does not prohibit, a 'matrix presentation'.

16.9 Business and Geographical Segments

Generally Business and Geographical segments are determined on the basis of internal financial reporting to the board of directors and the chief executive officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered for:

- a. If one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions but others are not, paragraph below should be applied only to those internal segments that do not meet the definitions.
- b. For those segments reported internally to the directors and management that do not satisfy the definitions, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions and
- c. If such an internally reported lower-level segment meets the definition of business segment or geographical segment, the criteria for identifying reportable segments should be applied to that segment.

16.10 Identifying Reportable Segments (Quantitative Thresholds)

A business segment or geographical segment should be identified as a reportable segment if:

- a. Its revenue from sales to external customers and from transactions with other segments is 10 per cent or more of the total revenue, external and internal, of all segments; or
- b. Its segment result, whether profit or loss, is 10 per cent or more of –
 - (i) The combined result of all segments in profit, or
 - (ii) The combined result of all segments in loss,
 - (iii) Whichever is greater in absolute amount; or
- c. Its segment assets are 10 per cent or more of the total assets of all segments.

A business segment or a geographical segment which is not a reportable segment as per above paragraph, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

If total external revenue attributable to reportable segments constitutes less than 75 per cent of the total enterprise revenue, additional segments should be identified as reportable segments, even if they do not meet the 10 per cent thresholds, until at least 75 per cent of total enterprise revenue is included in reportable segments.

A segment identified as a reportable segment in the immediately preceding period because it

satisfied the relevant 10 per cent thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10 percent thresholds.

If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10 per cent thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10 per cent thresholds in the preceding period.

16.11 Segment Accounting Policies

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. This Statement does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance and (b) the basis of measurement for this additional information is clearly described. Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

16.12 Primary Reporting Format

An enterprise should disclose the following for each reportable segment:

- a. Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
- b. Segment result;
- c. Total carrying amount of segment assets;
- d. Total amount of segment liabilities;
- e. Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
- f. Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
- g. Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets that were included in segment expense and, therefore, deducted in measuring segment result.

An enterprise is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the segment for the period. Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items. The disclosure, however,

does change the level at which the significance of such items is evaluated for disclosure purposes from the enterprise level to the segment level.

AS 3, recommends that an enterprise present a cash flow statement that separately reports cash flows from operating, investing and financing activities. Disclosure of information regarding operating, investing and financing cash flows of each reportable segment is relevant to understanding the enterprise's overall financial position, liquidity, and cash flows. Disclosure of segment cash flow is, therefore, encouraged, though not required. An enterprise that provides segment cash flow disclosures need not disclose depreciation and amortisation expense and non-cash expenses.

An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

16.13 Secondary Segment Information

If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:

- a. Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue;
- b. The total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments; and
- c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10 per cent or more of the total assets of all geographical segments.

If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue or whose segment assets are 10 per cent or more of the total assets of all business segments:

- a. Segment revenue from external customers;
- b. The total carrying amount of segment assets; and
- c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external

customers for each customer-based geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in different geographical areas from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10 per cent or more of total enterprise amounts:

- a. The total carrying amount of segment assets by geographical location of the assets.
- b. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by location of the assets.

16.14 Disclosures

In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed in accordance with AS. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

Some changes in accounting policies may relate specifically to segment reporting.

Example could be:

- changes in identification of segments; and
- changes in the basis for allocating revenues and expenses to segments.

Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effects of the change, if reasonably determinable.

An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

Illustration 1

Prepare a segmental report for publication in Diversifiers Ltd. from the following details of the company's three divisions and the head office:

	₹ ('000)
Forging Shop Division	

1.176 Financial Reporting

Sales to Bright Bar Division	4,575
Other Domestic Sales	90
Export Sales	<u>6,135</u>
	<u>10,800</u>
<i>Bright Bar Division</i>	
Sales to Fitting Division	45
Export Sales to Rwanda	<u>300</u>
	<u>345</u>
<i>Fitting Division</i>	
Export Sales to Maldives	<u>270</u>

Particulars	Head Office ₹ ('000)	Forging Shop Division ₹ ('000)	Bright Bar Division ₹ ('000)	Fitting Division ₹ ('000)
Pre-tax operating result		240	30	(12)
Head office cost reallocated		72	36	36
Interest costs		6	8	2
Fixed assets	75	300	60	180
Net current assets	72	180	60	135
Long-term liabilities	57	30	15	180

Solution

Diversifiers Ltd. Segmental Report

(₹ '000)

Particulars	Divisions			Inter Segment Eliminations	Consolidated Total
	Forging shop	Bright Bar	Fitting		
Segment revenue					
Sales:					
Domestic	90	—	—	—	90
Export	<u>6,135</u>	<u>300</u>	<u>270</u>	—	<u>6,705</u>
External Sales	6,225	300	270	—	6,795
Inter-segment sales	<u>4,575</u>	<u>45</u>	—	<u>4,620</u>	—
Total revenue	<u>10,800</u>	<u>345</u>	<u>270</u>	<u>4,620</u>	<u>6,795</u>
Segment result (given)	240	30	(12)		258
Head office expenses					<u>(144)</u>

Operating profit					114
Interest expense					(16)
Profit before tax					<u>98</u>
<i>Information in relation to assets and liabilities:</i>					
Fixed assets	300	60	180	–	540
Net current assets	<u>180</u>	<u>60</u>	<u>135</u>	–	<u>375</u>
Segment assets	<u>480</u>	<u>120</u>	<u>315</u>	–	915
Unallocated corporate assets (75 + 72)	–	–	–	–	<u>147</u>
Total assets					<u>1,062</u>
Segment liabilities	30	15	180	–	225
Unallocated corporate liabilities					<u>57</u>
Total liabilities					<u>282</u>

Sales Revenue by Geographical Market

	Home Sales	Export Sales (by forging shop division)	Export to Rwanda	Export to Maldives	(₹ '000) Consolidated Total
External sales	90	6,135	300	270	6,795

Illustration 2

Microtech Ltd. produces batteries for scooters, cars, trucks, and specialised batteries for invertors and UPS. How many segments should it have and why?

Answer

In case of Microtech Ltd., the basic product is the batteries, but the risks and returns of the batteries for automobiles (scooters, cars and trucks) and batteries for invertors and UPS are affected by different set of factors. In case of automobile batteries, the risks and returns are affected by the Government policy, road conditions, quality of automobiles, etc. whereas in case of batteries for invertors and UPS, the risks and returns are affected by power condition, standard of living, etc. Therefore, it can be said that Microtech Ltd. has two business segments viz- 'Automobile batteries' and 'batteries for Invertors and UPS'.

Reference: The students are advised to refer the full text of AS 17 "Segment Reporting".