UNIT 17 : AS 18: RELATED PARTY DISCLOSURES

17.1 Introduction

This Standard came into effect in respect of accounting periods commenced on or after 1-4-2001 and is mandatory in nature. The standard prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company. Since the standard is more subjective, particularly with respect to identification of related parties [though provisions related to related party concept are given under sections 297 / 299 / 301 of the Companies Act, 1956* and Section 40A (2)(b) of the Income Tax Act, 1961], obtaining corroborative evidence becomes very difficult for the auditors. Thus, successful implementation of AS 18 is dependent upon how transparent the management is and how vigilant the auditors are.

17.2 Objective

The objective of this Standard is to establish requirements for disclosure of:

(a) Related party relationships and

(b) Transactions between a reporting enterprise and its related parties.

17.3 Scope

AS 18 should be applied:

- In reporting related party relationships and transactions between a reporting enterprise and its related parties.
- Only to the related party relationships described in (a) to (e) below.
- To the financial statements of each reporting enterprise as also to consolidate financial statements presented by a holding company.

This Standard deals only with related party relationships described in (a) to (e) below:

a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).

b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.

* Now sections 188 / 184 / 189 of the Companies Act, 2013 respectively.

d. Key management personnel and relatives of such personnel and

e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

17.4 Definitions of the Terms used in the Accounting Standard

In the context of this Statement, the following are deemed not to be related parties:

a. Two companies simply because they have a director in common, notwithstanding paragraph (d) or (e) above (unless the director is able to affect the policies of both companies in their mutual dealings).

b. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence and

c. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

   (i) Providers of finance.

   (ii) Trade unions.

   (iii) Public utilities.

   (iv) Government departments and government agencies including government sponsored bodies.

Related party disclosure requirements as laid down in this Statement do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

Disclosure of transactions between members of a group is unnecessary in consolidated financial statements because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise. No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

Related party transaction: A transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

Related party: Parties are consider to be related, if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Illustration 1

Identify the related parties in the following cases as per AS 18

A Ltd. holds 51% of B Ltd.

B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

Solution

A Ltd., B Ltd. & O Ltd. are related to each other. Z Ltd. & O Ltd. are related to each other by virtue of Associate relationship. However, neither A Ltd. nor B Ltd. is related to Z Ltd. and vice versa.

Control: (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or

(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or

(c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

For the purpose of this Statement, an enterprise is considered to control the composition of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of that company/enterprise. An enterprise is deemed to have the power to appoint, if any of the following conditions is satisfied:

(a) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid or

(b) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise or

(c) The director/member is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

An enterprise/individual is considered to have a substantial interest in another enterprise if that enterprise or individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise.

An Associate: An enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

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

It may be exercised in several ways, by representation on the board of directors, participation in the policy making process, material inter-company transactions, interchange of managerial personnel or dependence on technical information.

Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investing party holds, directly or indirectly through intermediaries, 20 per cent or more of the voting power of the enterprise, it is presumed that the investing party does have significant influence, unless it can be clearly demonstrated that this is not the case, vice versa. A substantial or majority ownership by another investing party does not necessarily preclude an investing party from having significant influence.

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

A non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

The requirements of this standard should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise, unless he falls in any of the other categories.

Relative: In relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

Joint Venture - a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

Joint Control– the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

Holding Company– a company having one or more subsidiaries.

Subsidiary - a company:

(a) in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half, in nominal value of its equity share capital; or

(b) of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

Fellow subsidiary– a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

17.5 The Related Party Issue

Without related party disclosures, there is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into. Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties.

The operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties.

In view of the aforesaid, the resulting accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the

financial position and operating results of the reporting enterprise.

As per the Guidance Note on 'Remuneration paid to Key Management Personnel - Whether a Related Party Transaction', remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

17.6 Disclosure

Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

This is to enable users of financial statements to form a view about the effects of related party relationships on the enterprise.

If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

(i) The name of the transacting related party;

(ii) A description of the relationship between the parties;

(iii) A description of the nature of transactions;

(iv) Volume of the transactions either as an amount or as an appropriate proportion;

(v) Any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

(vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

(viii) Items of a similar nature may be disclosed in aggregate by type of related party.

17.7 Miscellaneous Illustrations

Illustration 2

Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3-2017. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?

Solution

As per paragraph 13 of AS 18 'Related Party Disclosures', Enterprises over which a key management

personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise.

In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is wrong.

Illustration 3

Mr. Raj a relative of key management personnel received remuneration of ₹ 2,50,000 for his services in the company for the period from 1.4.2016 to 30.6.2016. On 1.7.2016, he left the service.

Should the relative be identified as at the closing date i.e. on 31.3.2017 for the purposes of AS 18?

Solution

According to para 10 of AS 18 on Related Party Disclosures, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Raj, a relative of key management personnel should be identified as relative as at the closing date i.e. on 31.3.2017.

Illustration 4

X Ltd. sold goods to its associate Company for the 1st quarter ending 30.6.2017. After that, the related party relationship ceased to exist. However, goods were supplied as was supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.

Solution

As per para 23 of AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2017 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist need not be reported.

Reference: The students are advised to refer the full text of AS 18 "Related Party Disclosures".

UNIT 18 : AS 19 : LEASES

18.1 Introduction

This Standard came into effect in respect of all assets leased during accounting periods commenced on or after 1.4.2001 and is mandatory in nature. AS 19 prescribes the accounting and disclosure requirements for both finance leases and operating leases in the books of the lessor and lessee. The classification of leases adopted in this standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor and the lessee.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership.

An operating lease is a lease other than finance lease.

At the inception of the lease, assets under finance lease are capitalized in the books of lessee with corresponding liability for lease obligations as against the operating lease, wherein lease payments are recognized as an expense in profit and loss account on a systematic basis (i.e. straight line) over the lease term without capitalizing the asset. The lessor should recognise receivable at an amount equal to net investment in the lease in case of finance lease, whereas under operating lease, the lessor will present the leased asset under fixed assets in his balance sheet besides recognizing the lease income on a systematic basis (i.e. straight line) over the lease term. The person (lessor/lessee) presenting the leased asset in his balance sheet should also consider the additional requirements of AS 10.

18.2 Scope

This Standard is applied in accounting for all leases other than:

a. Lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights and

b. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights and

c. Lease agreements to use lands.

AS 19 applies to contracts that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. Examples include the supply of property, vehicles and computers.

On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase

agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

18.3 Definition of the Terms used under AS 19

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

An operating lease is a lease other than a finance lease.

A non-cancellable lease is a lease that is cancellable only:

a. Upon the occurrence of some remote contingency or

b. With the permission of the lessor or

c. If the lessee enters into a new lease for the same or an equivalent asset with the same lessor;

d. Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

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

Minimum lease payments are the payments over the lease term that the lessee is, or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

a. In the case of the lessee, any residual value guaranteed by or on behalf of the lessee or

b. In the case of the lessor, any residual value guaranteed to the lessor:

   (i) By or on behalf of the lessee or

   (ii) By an independent third party financially capable of meeting this guarantee.

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

Mr. X took mine on lease from Mr. Y on the terms that he would pay ₹ 10,000 or ₹ 10 per ton extracted during the year, whichever is less. ₹ 10 per ton been contingent cannot be included in minimum lease

payment calculation.

Economic life is either:

a. The period over which an asset is expected to be economically usable by one or more users;

b. The number of production or similar units expected to be obtained from the asset by one or more users.

Useful life of a leased asset is either:

a. The period over which the leased asset is expected to be used by the lessee or

b. The number of production or similar units expected to be obtained from the use of the asset by the lessee.

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

Guaranteed residual value is:

a. In the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable) and

b. In the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

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

We can say that:

Residual Value of the Assets = Guaranteed Residual Value + Unguaranteed Residual Value

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

Unearned finance income is the difference between:

a. The gross investment in the lease and

b. The present value of

   (i) The minimum lease payments under a finance lease from the standpoint of the lessor and

   (ii) Any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

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

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

a. The minimum lease payments under a finance lease from the standpoint of the lessor and

b. Any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

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

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices and market rates of interest).

18.4 Classification of Leases

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which individually or in combination would normally lead to a lease being classified as a finance lease are:

a. The lease transfers ownership of the asset to the lessee by the end of the lease term.

b. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

c. The lease term is for the major part of the economic life of the asset even if title is not transferred.

d. At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset or

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

Other indicators that, individually or in combination, could also lead to a lease being classified as a finance lease are:

a. If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

b. Gains or losses from the fluctuation in the fair value of the residual fall to the lessee and

c. The lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease after inception, other than by renewing the lease, in

a manner that would have resulted in a different classification, had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates or changes in circumstances, however, do not give rise to a new classification of a lease for accounting purposes.

18.5 Leases in the Financial Statements of Lessees

18.5.1 Finance Leases:

Both the leased asset and the related lease obligation (liability) should be recorded in the balance sheet at the inception of a finance lease.

Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

In the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

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

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability.

The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

18.5.2 Operating Leases

Rentals payable under an operating lease should be charged as an expense in the statement of profit and loss on a straight-line basis over the lease term, even if the payments are not made

on that basis, unless another systematic basis is more representative of the time pattern of the user's benefit. For example, where the rental payments for an asset are based on the actual usage of that asset, or are revised periodically to reflect the efficiency of the asset or current market rates, the rentals actually payable may be an appropriate measure.

18.5.3 Disclosure Requirements

Lessees are required to make the following disclosures for Finance leases:

- Assets acquired under finance lease as segregated from assets owned;
- For each class of assets, the net carrying amount at the balance sheet date;
- A reconciliation between the total of future minimum lease payments at the balance sheet date, and their present value; (SMC are exempt from this disclosure requirement)
- The total of future minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
  - Not later than one year;
  - Later than one year and not later than five years; and
  - Later than five years;

  (SMCs are exempt from this disclosure requirement)
- Contingent rents recognized as an expense in the period;
- The total of future minimum sublease payments expected to be received under non-cancellable sub-leases at the balance sheet date (SMCs are exempt from this disclosure requirement); and
- A general description of the lessee's material leasing arrangements including, but not limited to, the following:
  - The basis on which contingent rents are determined;
  - The existence and terms of renewal or purchase options and escalation clauses; and
  - Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

(SMCs are exempt from this disclosure requirement)

Note that in addition to the above the disclosure requirements of AS 10 apply equally to assets held under finance leases.

Operating leases:

a. The total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
   (i) Not later than one year;
   (ii) Later than one year and not later than five years;

(iii) Later than five years;

b. The total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

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

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

e. A general description of the lessee's significant leasing arrangements including, but not limited to, the following:

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

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

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

18.6 Leases in the Financial Statements of Lessors

18.6.1 Finance Lease

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable and sales in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. The transaction is recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded is the present value so computed. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

a. The profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts;

b. The finance income over the lease term.

Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged and balance will be adjusted with the finance income over the lease term.

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

18.6.2 Disclosure

The lessor should make the following disclosures for finance leases:

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

   (i) Not later than one year;

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

   (iii) Later than five years;

b. Unearned finance income;

c. The unguaranteed residual values accruing to the benefit of the lessor;

d. The accumulated provision for uncollectible minimum lease payments receivable;

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

f. A general description of the significant leasing arrangements of the lessor; and

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

Illustration 1 (finance lease)

'A' leased a machine from 'B' on the following terms:

a. The ownership of the machine will be transferred to 'A' on expiry of the lease period at ₹8,900.

b. Installation cost of the machine ₹5,000.

c. The cost of the machine is ₹1,09,240.

d. Lease agreement is signed for 5 years.

e. Minimum Lease Payment is ₹28,000 p.a.

f. First installment is Payable on 01.04.2017.

g. Depreciation is charged @ 25% p.a. on WDV.

You are required to show the complete chart of principle amount and implicit rate of interest for 5 years and also the journal entries in the books of 'A and B' for the period 01.04.2017 to 31.03.2019.

Solution

First calculate the implicit rate of return, i.e. the rate of Present Value at which the PV of Minimum Lease Payment equals to Market Price of the Assets on the date of lease agreement.

Lease Payment	*Present Value Factor @ 12%*	*Present Value of Lease Payment*	*Present Value Factor @ 14%*	*Present Value of Lease Payment*
(a)	*(b)*	*(c= a x b)*	*(d)*	*(e = a x d)*
28,000	1	28,000	1	28,000
28,000	0.893	25,000	0.877	24,561
28,000	0.797	22,321	0.769	21,545
28,000	0.712	19,930	0.675	18,899
28,000	0.636	17,795	0.592	16,578
8,900	0.567	5,050	0.519	4,622
		118,096		114,206

Installment	*Opening Balance*	*Interest Amount*	*Principle Amount*	*Closing Balance*
	(a)			
1	114,240	-	28,000	86,240
2	86,240	12,074	15,926	70,314
3	70,314	9,844	18,156	52,158
4	52,158	7,302	20,698	31,460
5	31,460	4,404	23,596	7,864
	7,864	1,036	7,864	(0)

Journal Entries

In the Books of Mr. A				*In the Books of Mr. B*		
Date	*Particulars*	*Dr.*	*Cr.*	*Particulars*	*Dr.*	*Cr.*
Purchase of Machine on Lease:						
2017						
01-April	Machine on Lease A/c Dr.	114,240		Mr. A A/c Dr.	1,14,240	
	To Mr. B A/c		1,14,240	To Lease Sales A/c		1,14,240
Payment of First Installment:						
	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000

Interest due for the First Year @ 14% p.a.:						
2015						
31-March	Interest A/c Dr.	12,074		Mr. A A/c Dr.	12,074	
	To Mr. B A/c		12,074	To Interest A/c		12,074
Charging Depreciation:						
	Depreciation A/c Dr.	28,560				
	To Machine A/c		28,560			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	40,634		Interest A/c Dr.	12,074	
	To Interest A/c		12,074	To Profit & Loss A/c		12,074
	To Depreciation A/c		28,560			
Payment of Second Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Second Year @ 14% p.a.:						
2016						
31-March	Interest A/c Dr.	9,844		Mr. A A/c Dr.	9,844	
	To Mr. B A/c		9,844	To Interest A/c		9,844
Charging Depreciation:						
	Depreciation A/c Dr.	21,420				
	To Machine A/c		21,420			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	31,264		Interest A/c Dr.	9,844	
	To Interest A/c		9,844	To Profit & Loss A/c		9,844
	To Depreciation A/c		21,420			
Payment of Third Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Third Year @ 14% p.a.:						
2017						
31-March	Interest A/c Dr.	7,302		Mr. A A/c Dr.	7,302	
	To Mr. B A/c		7,302	To Interest A/c		7,302
Charging Depreciation:						
	Depreciation A/c Dr.	16,065				

	To Machine A/c		16,065			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	23,367		Interest A/c Dr.	7,302	
	To Interest A/c		7,302	To Profit & Loss A/c		7,302
	To Depreciation A/c		16,065			
Payment of Fourth Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Fourth Year @ 14% p.a.:						
2018						
31-March	Interest A/c Dr.	4,404		Mr. A A/c Dr.	4,404	
	To Mr. B A/c		4,404	To Interest A/c		4,404
Charging Depreciation:						
	Depreciation A/c Dr.	12,049				
	To Machine A/c		12,049			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	16,453		Interest A/c Dr.	4,404	
	To Interest A/c		4,404	To Profit & Loss A/c		4,404
	To Depreciation A/c		12,049			
Payment of Fifth Installment:						
01-April	Mr. B A/c Dr.	28,000		Bank A/c Dr.	28,000	
	To Bank A/c		28,000	To Mr. A A/c		28,000
Interest due for the Last Year @ 14% p.a.:						
2019						
31-March	Interest A/c Dr.	1,036		Mr. A A/c Dr.	1,036	
	To Mr. B A/c		1,036	To Interest A/c		1,036
Charging Depreciation:						
	Depreciation A/c Dr.	9,037				
	To Machine A/c		9,037			
Transfer to Profit & Loss Account:						
	Profit & Loss A/c Dr.	10,073		Interest A/c Dr.	1,036	
	To Interest A/c		1,036	To Profit & Loss A/c		1,036
	To Depreciation A/c		9,037			
Purchase of Asset on expiry of Lease Term:						
	Mr. B A/c Dr.	8,900		Bank A/c Dr.	8,900	
	To Bank A/c		8,900	To Mr. A A/c		8,900

18.6.3 Operating Leases

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

Lease income should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Initial direct costs incurred are either deferred and allocated to income over the lease term in proportion to the recognition of rent income or are recognised as an expense in the statement of profit and loss in the period in which they are incurred. For charging depreciation and impairment of assets, relevant Accounting Standards should be followed.

18.6.4 Disclosures

a. For each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and
   - (i) The depreciation recognised in the statement of profit and loss for the period;
   - (ii) Impairment losses recognised in the statement of profit and loss for the period;
   - (iii) Impairment losses reversed in the statement of profit and loss for the period;

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

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

d. A general description of the lessor's significant leasing arrangements; and

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

Illustration 2 (Operating lease)

Geeta purchased a computer for ₹ 44,000 and leased out it to Sita for four years on leases basis, after the lease period, value of the computer was estimated to be ₹ 3,000; which she realised after selling it in the second hand market. Lease amount payable at the beginning of each year is ₹ 22,000; ₹ 13,640; ₹ 6,820 & ₹ 3,410. Depreciation was charged @ 40% p.a. You are required to pass the necessary journal entries in the books of both Geeta and Sita.

Solution

In the Books of Geeta				*In the Books of Sita*		
Date	*Particulars*	*Dr.*	*Cr.*	*Particulars*	*Dr.*	*Cr.*
Purchase of computers:						
1st	Computer A/c Dr.	44,000				

	To Bank A/c		44,000			
Payment of first year's lease:						
	Bank A/c Dr.	22,000		Lease Rent Paid A/c Dr.	22,000	
	To Lease Rent A/c		22,000	To Bank A/c		22,000
Depreciation for first year:						
	Depreciation A/c Dr.	17,600				
	To Machine A/c		17,600			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	17,600		Profit & Loss A/c Dr.	22,000	
	To Depreciation A/c		17,600	To Lease Rent Paid A/c		22,000
	Lease Rent A/c Dr.	22,000				
	To Profit & Loss A/c		22,000			
Payment of second year's lease:						
2nd	Bank A/c Dr.	13,640		Lease Rent Paid A/c Dr.	13,640	
	To Lease Rent A/c		13,640	To Bank A/c		13,640
Depreciation for second year:						
	Depreciation A/c Dr.	10,560				
	To Machine A/c		10,560			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	10,560		Profit & Loss A/c Dr.	13,640	
	To Depreciation A/c		10,560	To Lease Rent Paid A/c		13,640
	Lease Rent A/c Dr.	13,640				
	To Profit & Loss A/c		13,640			
Payment of third year's lease:						
3rd	Bank A/c Dr.	6,820		Lease Rent Paid A/c Dr.	6,820	
	To Lease Rent A/c		6,820	To Bank A/c		6,820
Depreciation for third year:						
	Depreciation A/c Dr.	6,336				
	To Machine A/c		6,336			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	6,336		Profit & Loss A/c Dr.	6,820	
	To Depreciation A/c		6,336	To Lease Rent Paid A/c		6,820
	Lease Rent A/c Dr.	6,820				
	To Profit & Loss A/c		6,820			

Payment of fourth year's lease:						
4th	Bank A/c Dr.	3,410		Lease Rent Paid A/c. Dr.	3,410	
	To Lease Rent A/c		3,410	To Bank A/c		3,410
Depreciation for fourth year:						
	Depreciation A/c Dr.	3,802				
	To Machine A/c		3,802			
Transfer to profit & loss account:						
	Profit & Loss A/c Dr.	3,802		Profit & Loss A/c Dr.	3,410	
	To Depreciation A/c		3,802	To Lease Rent Paid A/c		3,410
	Lease Rent A/c Dr.	3,410				
	To Profit & Loss A/c		3,410			
Sale of lease asset:						
	Bank Account Dr.	3,000				
	Loss on Sale A/c Dr.	2,702				
	To Computer A/c		5,702			

18.7 Sale and Leaseback Transactions

A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

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

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

Illustration 3

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

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

(b) Fair value is ₹ 60 lakhs.

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

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

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

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

Solution

Following will be the treatment in the given cases:

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

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

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

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

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

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

18.8 Miscellaneous Illustrations

Illustration 4

A Ltd. leased a machinery to B Ltd. on the following terms:

	(₹ in lakhs)
Fair value of the machinery	*20.00*
Lease term	*5 years*
Lease Rental per annum	*5.00*
Guaranteed Residual value	*1.00*
Expected Residual value	*2.00*
Internal Rate of Return	*15%*

Depreciation is provided on straight line method @ 10% per annum. Ascertain unearned financial income and necessary entries may be passed in the books of the Lessee in the First year.

Solution

Computation of Unearned Finance Income

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

where:

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

Gross investment = Minimum lease payments + Unguaranteed residual value

=(Total lease rent + Guaranteed residual value) + Unguaranteed residual value

= [(₹ 5,00,000 × 5 years) + ₹ 1,00,000] + ₹ 1,00,000

= ₹ 27,00,000

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

Year	*MLP inclusive of URV*	*Internal rate of return (Discount factor 15%)*	*Present Value*	
	₹		₹	
1	5,00,000	.8696	4,34,800	
2	5,00,000	.7561	3,78,050	
3	5,00,000	.6575	3,28,750	
4	5,00,000	.5718	2,85,900	
5	5,00,000	.4972	2,48,600	
	1,00,000	.4972	49,720	
	(guaranteed residual value)			
			17,25,820	(i)
	1,00,000	.4972	49,720	(ii)
	(unguaranteed residual value)			
		(i) + (ii)	17,75,540	(b)

Unearned Finance Income = (a) – (b)

= ₹ 27,00,000–₹ 17,75,540 = ₹ 9,24,460

Journal Entries in the books of B Ltd.

	₹	₹
At the inception of lease		

Machinery account	Dr.	17,25,820*	
To A Ltd.'s account			17,25,820*
(Being lease of machinery recorded at present value of MLP)			
At the end of the first year of lease			
Finance charges account (Refer Working Note)	Dr.	2,58,873	
To A Ltd.'s account			2,58,873
(Being the finance charges for first year due)			
A Ltd.'s account	Dr.	5,00,000	
To Bank account			5,00,000
(Being the lease rent paid to the lessor which includes outstanding liability of ₹ 2,41,127 and finance charge of ₹ 2,58,873)			
Depreciation account	Dr.	1,72,582	
To Machinery account			1,72,582
(Being the depreciation provided @ 10% p.a. on straight line method)			
Profit and loss account	Dr.	4,31,455	
To Depreciation account			1,72,582
To Finance charges account			2,58,873
(Being the depreciation and finance charges transferred to profit and loss account)			

Working Note:

Table showing apportionment of lease payments by B Ltd. between the finance charges and the reduction of outstanding liability.

Year	*Outstanding liability (opening balance)* ₹	*Lease rent* ₹	*Finance charge* ₹	*Reduction in outstanding liability* ₹	*Outstanding liability (closing balance)* ₹
1	17,25,820	5,00,000	2,58,873	2,41,127	14,84,693

*As per para 11 of AS 19, the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of ₹ 20,00,000 is more than the present value amounting ₹ 17,25,820, the machinery has been recorded at ₹ 17,25,820 in the books of B Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

2	14,84,693	5,00,000	2,22,704	2,77,296	12,07,397
3	12,07,397	5,00,000	1,81,110	3,18,890	8,88,507
4	8,88,507	5,00,000	1,33,276	3,66,724	5,21,783
5	5,21,783	5,00,000	78,267	5,21,783	1,00,050*
			8,74,230	17,25,820	

*The difference between this figure and guaranteed residual value (₹ 1,00,000) is due to approximation in computing the interest rate implicit in the lease.

Illustration 5

Global Ltd. has initiated a lease for three years in respect of an equipment costing ₹ 1,50,000 with expected useful life of 4 years. The asset would revert to Global Limited under the lease agreement. The other information available in respect of lease agreement is:

(i) The unguaranteed residual value of the equipment after the expiry of the lease term is estimated at ₹ 20,000.

(ii) The implicit rate of interest is 10%.

(iii) The annual payments have been determined in such a way that the present value of the lease payment plus the residual value is equal to the cost of asset.

Ascertain in the hands of Global Ltd.

(i) The annual lease payment.

(ii) The unearned finance income.

(iii) The segregation of finance income, and also,

(iv) Show how necessary items will appear in its profit and loss account and balance sheet for the various years.

Solution

(i) Calculation of Annual Lease Payment*

	₹
Cost of the equipment	1,50,000
Unguaranteed Residual Value	20,000
PV of residual value for 3 years @ 10% (₹ 20,000 x 0.751)	15,020
Fair value to be recovered from Lease Payment(₹ 1,50,000 – ₹ 15,020)	1,34,980
PV Factor for 3 years @ 10%	2.487
Annual Lease Payment (₹ 1,34,980 / PV Factor for 3 years @ 10% i.e. 2.487)	54,275

*Annual lease payments are considered to be made at the end of each accounting year.

(ii) Unearned Financial Income

Total lease payments [₹ 54,275 x 3]	1,62,825
Add: Residual value	20,000
Gross Investments	1,82,825
Less: Present value of Investments (₹ 1,34,980 + ₹ 15,020)	1,50,000
Unearned Financial Income	32,825

(iii) Segregation of Finance Income

Year	*Lease Rentals* ₹	*Finance Charges @10% on outstanding amount of the year* ₹	*Repayment* ₹	*Outstanding Amount* ₹
0	-	-	-	1,50,000
I	54,275	15,000	39,275	1,10,725
II	54,275	11,073	43,202	67,523
III	74,275**	6,752	67,523	--
	1,82,825	32,825	1,50,000	

(iv) Profit and Loss Account (Relevant Extracts)

Credit side		₹
I Year	By Finance Income	15,000
II year	By Finance Income	11,073
III year	By Finance Income	6,752

Balance Sheet (Relevant Extracts)

Assets side	₹	₹
I year Lease Receivable	1,50,000	
Less: Amount Received	39,275	1,10,725
II year Lease Receivable	1,10,725	
Less: Received	(43,202)	67,523
III year :Lease Amount Receivable	67,523	
Less: Amount received	(47,523)	
Residual value	(20,000)	NIL

Notes to Balance Sheet

Year 1	₹
Minimum Lease Payments (54,275 + 54,275)	1,08,550
Residual Value	20,000
	1,28,550
Unearned Finance Income(11,073+ 6,752)	(17,825)

**₹ 74,275 include unguaranteed residual value of equipment amounting ₹ 20,000.

Lease Receivables	1,10,725
Classification:	
Not later than 1 year	43,202
Later than 1 year but not more than 5 years	67,523
Total	1,10,725
Year II:	
Minimum Lease Payments	54,275
Residual Value (Estimated)	20,000
	74,275
Unearned Finance Income	(6,752)
Lease Receivables (not later than 1 year)	67,523
III Year:	
Lease Receivables (including residual value)	67,523
Amount Received	67,523
	NIL

Reference: The students are advised to refer the full text of AS 19 "Leases").

UNIT 19 : AS 20: EARNINGS PER SHARE

19.1 Introduction

AS 20 came into effect in respect of accounting period commenced on or after 1-4-2001 and is mandatory in nature. The objective of this standard is to describe principles for determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement.

Every company, which is required to give information under Schedule III to the Companies Act, 2013, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

19.2 Definition of the terms used in the Accounting Standard

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

For this purpose, a financial asset is any asset that is

a. Cash;

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

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

d. An equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

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

Examples of potential equity shares are:

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

b. Share warrants;

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

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

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

19.3 Basic Earnings per Share

Basic earnings per share is calculated as

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

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS 5 requires or permits otherwise.

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

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

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

b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

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

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

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

The calculation is based on all shares outstanding during the period. Whether or not a particular class or tranche of shares ranked for dividends in respect of the period is irrelevant (except in the case of partly paid shares).

The time-weighting factor is:

$$\frac{\text{Numbers of days the shares are outstanding}}{\text{Number of days in the period}}$$

Although the Standard defines the time-weighting factor as being determined on a daily basis, it acknowledges that a reasonable approximation of the weighted average is adequate in many circumstances.

Depending on the relative size of share movements, this might, for example, be based on the number of months for which shares were outstanding.

Illustration 1

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

Calculate Weighted Number of Shares.

Solution

Computation of Weighted Average:

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

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

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

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

a. Equity shares issued in exchange for cash are included when cash is receivable;

b. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

c. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

d. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

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

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

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

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

a. A bonus issue;

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

c. A share split; and

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

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Illustration 2

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

Calculate Weighted Number of Shares.

Solution

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

Computation of weighted average would be as follows:

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

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Illustration 3

Net profit for the year 2016	*₹ 18,00,000*
Net profit for the year 2017	*₹ 60,00,000*
No. of equity shares outstanding until 30th September 2017	*20,00,000*

Bonus issue 1st October 2017 was 2 equity shares for each equity share outstanding at 30th September, 2017

Calculate Basic Earnings Per Share.

Solution

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

Earnings per share for the year 2017 $\frac{₹\ 60,00,000}{(20,00,000 + 40,00,000)}$ = ₹ 1.00

Adjusted earnings per share for the year 2016 $\frac{₹\ 18,00,000}{(20,00,000 + 40,00,000)}$ = ₹ 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2016, the earliest period reported.

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

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

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

Illustration 4

Net profit for the year 2016	*₹ 11,00,000*
Net profit for the year 2017	*₹ 15,00,000*

No. of shares outstanding prior to rights issue	*5,00,000 shares*
Rights issue price	*₹ 15.00*
Last date to exercise rights	*1st March 2017*

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

Fair value of one equity share immediately prior to exercise of rights on 1st March 2017 was ₹ 21.00. Compute Basic Earnings Per Share.

Solution

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

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

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} \quad \frac{₹\ (21.00)}{₹\ (20.00)} = 1.05$$

Computation of earnings per share:

EPS for the year 2016 as originally reported: ₹ 11,00,000/5,00,000 shares = ₹ 2.20

EPS for the year 2016 restated for rights issue: ₹ 11,00,000/ (5,00,000 shares x 1.05) = ₹ 2.10

EPS for the year 2017 including effects of rights issue:

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

EPS = 15,00,000/5,87,500 = ₹ 2.55

19.4 Diluted Earnings Per Share

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

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

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

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

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

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

For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

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

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

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

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

a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

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

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

Illustration 5

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

Compute Diluted Earnings Per Share.

Solution

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

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

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

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

19.5 Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

19.6 Presentation

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

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

19.7 Disclosure

An enterprise should disclose the following:

a. Where the statement of profit and loss includes extraordinary items (as defined is AS 5), basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense);

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

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

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

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

Illustration 6

Net profit for the year 2017	*₹ 12,00,000*
Weighted average number of equity shares outstanding during the year 2017	*5,00,000 shares*
Average fair value of one equity share during the year 2017	*₹ 20.00*
Weighted average number of shares under option during the year 2017	*1,00,000 shares*
Exercise price for shares under option during the year 2017	*₹ 15.00*

Compute Basic and Diluted Earnings Per Share.

Solution

Computation of earnings per share

	Earnings ₹	*Shares*	*Earnings/ Share* ₹
Net profit for the year 2017	12,00,000		
Weighted average no. of shares during year 2017		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (100,000 x 15.00)/20.00		(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

Illustration 7

From the Books of Bharti Ltd., following information are available as on 1.4.2015 and 1.4.2016:

(1)	*Equity Shares of ₹10 each*	*1,00,000*
(2)	*Partly paid Equity Shares of ₹10 each ₹5 paid*	*1,00,000*
(3)	*Options outstanding at an exercise price of ₹60 for one equity share ₹10 each. Average Fair Value of equity share during both years ₹75*	*10,000*
(4)	*10% convertible preference shares of ₹100 each. Conversion ratio 2 equity shares for each preference share*	*80,000*
(5)	*12% convertible debentures of ₹100. Conversion ratio 4 equity shares for each debenture*	*10,000*
(6)	*10% dividend tax is payable for the years ending 31.3.2017 and 31.3.2016.*	
(7)	*On 1.10.2016 the partly paid shares were fully paid up*	
(8)	*On 1.1.2017 the company issued 1 bonus share for 8 shares held on that date.*	

Net profit attributable to the equity shareholders for the years ending 31.3.2017 and 31.3.2016 were ₹10,00,000. Assume Tax rate at 30% for both the years.

Calculate:

(i) Earnings per share for years ending 31.3.2017 and 31.3.2016.

(ii) Diluted earnings per share for years ending 31.3.2017 and 31.3.2016.

(iii) Adjusted earnings per share and diluted EPS for the year ending 31.3.2016, assuming the same information for previous year, also assume that partly paid shares are eligible for proportionate dividend only.

Solution

(i) Earnings per share

	Year ended 31.3.2017	*Year ended 31.3.2016*
Net profit attributable to equity shareholders	₹ 10,00,000	₹ 10,00,000
Weighted average number of equity shares [(W.N. 1) – without considering bonus issue for the year ended 31.3.2017]	2,00,000	1,50,000
Earnings per share	₹ 5	₹ 6.667

(ii) Diluted earnings per share

Options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (as per W.N. 2).

Year ended 31.3.2017 Year ended 31.3.2016

	Net profit attributable to equity shareholders ₹	*No. of equity shares*	*Net Profit attributable per share ₹*	No. of equity shares *(without considering bonus issue)*	*Net Profit attributable per share ₹*
As reported (for years ended 31.3.2017 and 31.3.2016)	10,00,000	2,00,000	5	1,50,000	6.667
Options	_____	2,000		2,000	
	10,00,000	2,02,000	4.95 Dilutive	1,52,000	6.579 Dilutive
12% Convertible debentures	84,000	40,000		40,000	
	10,84,000	2,42,000	4.48 Dilutive	1,92,000	5.646 Dilutive
10% Convertible Preference Shares	8,80,000	1,60,000		1,60,000	
	19,64,000	4,02,000	4.886 Anti-Dilutive	3,52,000	5.58 Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (₹ 4.48 to ₹ 4.886), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share for the year ended 31.3.2017. Therefore, diluted earnings per share for the year ended 31st March, 2017 is ₹ 4.48.

For the year ended 31st March, 2016, Options, 12% Convertible debentures and Convertible preference shares will be considered dilutive and diluted earnings per share will be taken as ₹ 5.58.

	Year ended 31.3.2017	*Year ended 31.3.2016*
Diluted earnings per Share	4.48	5.58

(iii) Adjusted earnings per share and diluted earnings per share for the year ending 31.3.2016.

Net profit attributable to equity shareholders	₹ 10,00,000
Weighted average number of equity shares [(W.N. 1) – considering bonus issue]	1,75,000
Adjusted earnings per share	₹ 5.714

Calculation of adjusted diluted earnings per share

	Net profit attributable to equity shareholders ₹	*No. of equity shares (after considering bonus issue)*	*Net profit attributable per share* ₹
As reported	10,00,000	1,75,000	5.714
Options	_____	2,000	
	10,00,000	1,77,000	5.65 Dilutive
12% Convertible Debentures	84,000	40,000	
	10,84,000	2,17,000	4.995 Dilutive
10% Convertible Preference Shares	8,80,000	1,60,000	
	19,64,000	3,77,000	5.21 Anti –Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from ₹ 4.995 to ₹ 5.21), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, adjusted diluted earnings per share for year ended 31.3.2016 is ₹ 4.995.

Adjusted diluted earnings per share ₹ 4.995

Working Notes:

1. Weighted average number of equity shares

		31.3.2017 No. of Shares	*31.3.2016 No. of Shares*
(a)	Fully paid equity shares	1,00,000	1,00,000
(b)	Partly paid equity shares*		50,000
	Partly paid equity shares	25,000	
	Fully paid equity shares	50,000	
	(Partly paid shares converted into fully paid up on 1.10.2016)		

(c)	Bonus Shares**	25,000	_____
	Weighted average number of equity shares	2,00,000	1,50,000
	(without considering bonus issue for year ended 31.3.2016)		
	Bonus Shares		25,000
	Weighted average number of equity shares (after considering bonus issue for year ended 31.3.2016)		1,75,000

*Since partly paid equity shares are entitled to participate in dividend to the extent of amount paid, 1,00,000 equity shares of ₹ 10 each, ₹ 5 paid up will be considered as 50,000 equity shares for the year ended 31st March, 2016.

On 1st October, 2016 the partly paid shares were converted into fully paid up. Thus, the weighted average equity shares (for six months ended 30th September, 2016) will be calculated as

$$50,000 \times \frac{6}{12} = 25,000 \text{ shares}$$

Weighted average shares (for six months ended 31st March, 2017) will be calculated as

$$1,00,000 \times \frac{6}{12} = 50,000 \text{ shares}$$

**Total number of fully paid shares on 1st January, 2017

Fully paid shares on 1st April, 2016	1,00,000
Partly paid shares being made fully paid up on 1st October, 2016	1,00,000
	2,00,000

The company issued 1 bonus share for 8 shares held on 1st January, 2017.

Thus, 2,00,000/8 = 25,000 bonus shares will be issued.

Bonus is an issue without consideration, thus it will be treated as if it had occurred prior to the beginning of 1st April, 2015, the earliest period reported.

2. Increase in earnings attributable to equity shareholders on conversion of potential equity shares

	Increase in earnings *(1)*	*Increase in number of equity shares* *(2)*	*Earnings per incremental share* *(3) = (1) ÷ (2)*
	₹		₹
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration			
[10,000 × (75 – 60)/75]		2,000	Nil
Convertible Preference Shares			

Increase in net profit attributable to equity shareholders as adjusted by attributable dividend tax [(₹ 10 × 80,000) + 10% (₹ 10 × 80,000)]	8,80,000		
No. of incremental shares (2 × 80,000)		1,60,000	5.50
12% Convertible Debentures			
Increase in net profit [(₹ 10,00,000 × 0.12 × (1 – 0.30)]	84,000		
No. of incremental shares (10,000 × 4)		40,000	2.10

Note: Grossing up of preference share dividend has been ignored here.

Illustration 8

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

(Accounting year 1.1.2016– 31.12.2016)		
Net Profit	:	*Year 2016: ₹ 20,00,000*
	:	*Year 2017 : ₹ 30,00,000*
No. of shares outstanding prior to Right Issue	:	*10,00,000 shares*
Right Issue	:	*One new share for each four outstanding i.e., 2,50,000 shares.* *Right Issue price – ₹ 20* *Last date of exercise rights – 31.3.2017.*
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2017	:	*₹ 25*

Solution

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

	Year 2016 ₹	*Year 2017* ₹
EPS for the year 2016 as originally reported Net profit of the year attributable to equity shareholders Weighted average number of equity shares outstanding during the year = (₹ 20,00,000 / 10,00,000 shares)	2.00	

EPS for the year 2016 restated for rights issue = [₹ 20,00,000 / (10,00,000 shares × 1.04*)] EPS for the year 2017 including effects of rights issue $\frac{₹\ 30,00,000}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$ $\frac{₹\ 30,00,000}{11,97,500 \text{ shares}}$	1.92 (approx.)	2.51 (approx.)

Working Notes:

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

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

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

2. Computation of adjustment factor

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

<u>Reference</u>: The students are advised to refer the full text of AS 20 "Earnings per Share"

* Refer working note 2.

UNIT 20: AS 21: CONSOLIDATED FINANCIAL STATEMENTS

20.1 Introduction

This Standard came into effect in respect of accounting periods commenced on or after 1-4-2001. AS 21 lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by a parent (holding company) to provide financial information about the economic activities of the group as a single economic entity. A parent who presents consolidated financial statements should present their statements in accordance with this standard but in its separate financial statements, investments in subsidiaries should be accounted as per AS 13.

20.2 Objective

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated Financial Statement is prepared by the holding/parent company to provide financial information regarding the economic resources controlled by its group and results achieved with these resources. This consolidated financial statement is prepared by the parent company in addition to the financial statement prepared by the parent company for only its own affairs. Hence parent company prepares two financial statements, one for only its own affairs and one for taking the whole group as one unit in the form of consolidated financial statement. Consolidated financial statements usually comprise the following:

- Consolidated Balance Sheet
- Consolidated Profit & Loss Statement
- Notes to Accounts, other statements and explanatory material
- Consolidated Cash Flow Statement, if parent company presents its own cash flow statement.

While preparing the consolidated financial statement, all other ASs and Accounting Policies will be applicable as they are applied in parent company's own financial statement.

A parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign. Where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements, and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively.

20.3 Scope

This standard applies to the financial statement prepared by the parent company including the financial information of all its subsidiaries taken as one single financial unit. One should refer

to this AS for the investment in subsidiaries to be disclosed in the financial statement prepared by the parent company separately. But this standard does not deal with:

a. Methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (AS 14).

b. Accounting for investments in associates (AS 13) and

c. Accounting for investments in joint ventures (AS 13).

20.4 Definitions of the Terms used in the Accounting Standard

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities. **Minority interest** is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

20.5 Circumstances under which Consolidated Financial Statements are Prepared

AS 21 should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

AS 21 does not mandate which enterprises are required to prepare consolidated financial statements – but specifies the rules to be followed where such financial statements are prepared.

Consolidated Financial Statement will be prepared by the parent company for all the companies that are controlled by the parent company either directly or indirectly, situated in India or abroad except in the following cases:

a. Control is intended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in the near future.

   In view of the above, merely holding all the shares as 'inventory-in-trade', is not sufficient to be considered as temporary control. It is only when all the shares held as 'inventory-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, that control would be considered to be temporary within the meaning of the paragraph.

The term 'Near Future' is a period not exceeding 12 months in normal case. For the above purpose, one should note the intention at the time of making the investment, if the intention is to continue with the equity for longer period then even though it is disposed off within 12 months, investee company would still be considered as subsidiary. On the other hand, if intention at the time of purchase is dispose it in near future, but the parent company was not able to dispose of the shares even after the end of 12 months, shares will continue to be considered as inventory.

b. Or subsidiary company operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the parent.

When the parent company has some restrictions on bringing the resources of the subsidiary company to its main resources then consolidated financial statement is not required, as the control is not resulting in extra cash flow to parent company other than as mere investment in share of any other company i.e. dividend, bonus shares.

Therefore, in both the above cases, investment of parent company in the share of its subsidiary company is treated as investment according to AS 13.

Exclusion of subsidiary company will be only for any of the above reasons but a company cannot be treated as outside the group just because the main business of the subsidiary company is not in line with the business of parent company.

20.6 Subsidiaries with Dissimilar Activities

AS 21 states that it is inappropriate to exclude subsidiaries from consolidation on the ground that their business activities are substantially different from those of the parent and/or the rest of the group. As long as the parent retains control over such subsidiaries, they are required to be consolidated. Information regarding the different nature of the activities of a subsidiary can be appropriately disclosed by listed companies in accordance with AS 17 Segment Reporting.

20.7 Loss of Control

When a parent loses control, the investee no longer meets the definition of subsidiary, and so it is no longer consolidated.

Where a parent loses control over a subsidiary, the investment will be accounted for under AS 13 Accounting for Investments from the date of loss of control, provided that the investor does not retain significant influence (in which case the investment will be accounted for under AS 23)

20.8 Existence of Control

Control Exists when Parent Company has either:

a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise.

For example, A Ltd. holds 75% shares in B Ltd., then B Ltd. is subsidiary of A Ltd., in other words A Ltd. is the parent company.

If A Ltd. is holding 25% shares in C Ltd., then there is no holding-subsidiary relationship between them. But if along with A Ltd., B Ltd. also holds 30% shares in C Ltd., then A Ltd. holding in C Ltd. is 55%, though indirectly, and A Ltd. is parent company of both B Ltd. and C Ltd.

b. Or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from subsidiary company's activities.

Point to be noted here is that, the control over composition of board or governing body is for economic benefit. If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

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

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

(i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or

(ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or

(iii) The director/member is nominated by that enterprise or a subsidiary thereof.

If A Ltd. is proved to be a subsidiary company of B Ltd. by virtue of point (a) and also a subsidiary of C Ltd. as per point (b), then the problem arises that which company is liable to prepare Consolidated Financial Statement taking A Ltd. as its subsidiary. For this purpose, both B Ltd. and C Ltd. will prepare such Consolidated Financial Statement, group being constituted of themselves and A Ltd.

In addition to the above points, one should also consider the following points:

Determination of control in any company or organization, does not depend only on the share in capital, many a times even when the share in capital is less than 50% but still we consider the parent-subsidiary relationship as the voting power granted under special circumstances is more than 50%.

For example, ICICI Bank advanced loan of ₹ 40 crores to A Ltd., whose share capital is ₹ 10 crores only. As per the loan agreement, in case company defaults to repay the principal or to pay the interest on due date three times, ICICI Bank will have right to participate in the decision making of the company and this right will come to an end with the repayment of the loan amount with all its interest. On happening of the event,

ICICI Bank got the voting right in the company meetings (Board and AGM) and as its advances to company is 80% of shares plus advances, bank carry 80% voting right and we can say that there exists a parent-subsidiary relationship, where A Ltd. is subsidiary of ICICI Bank.

Control is said to come into existence from the date when the conditions of such control are satisfied. If company does have control over the function of another company but consolidated financial statement is not prepared for the reason that there is restriction of impairing the resources then later, on removal of such restriction control will be said to come into existence but not from the date of such removal but from the date when such investments led to control.

20.9 Consolidation Procedures

In preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line-by-line basis by adding together like items of assets, liabilities, income and expenses and then certain adjustments are made.

The consolidation adjustments required will vary depending on the circumstances. The adjustments include (but are not restricted to);

- The elimination of the cost of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary;
- recognition of goodwill or capital reserve, depending on whether the cost of the parent's investment in each subsidiary is greater than or less than the parent's portion of equity of each subsidiary at the date on which investment in the subsidiary is made;
- the identification of the minority interest in the profit or loss of consolidated subsidiaries for the reporting period;
- the identification of the minority interest in the net assets of consolidated subsidiaries for the reporting period;
- the elimination of all intra-group balances and intra-group transactions, and the resulting unrealised profits and losses;
- adjustment of the consolidated results for dividends related to outstanding cumulative preference shares of a subsidiary that are held by minority interests regardless of whether the dividends have been declared.

20.10 Cost of Control

- The cost of investment of the parent in each of its subsidiaries and the parent's share in equity of each subsidiary should be eliminated. For the purpose equity and investment as on the date of each investment is taken.

- On the date of investment if the cost of investment to the parent is more than share of equity in that particular subsidiary, the difference is taken as Goodwill in the consolidated statement.
- On the date of investment if the cost of investment to the parent is less than share of equity in that particular subsidiary, the difference is taken as Capital Reserve in the consolidated statement.

20.11 Illustrations

Illustration 1

A Ltd. acquired 60% shares of B Ltd. @ ₹ 20 per share. Following are the extract of Balance Sheet of B Ltd.:

	₹
10,00,000 Equity Shares of ₹ 10 each	*1,00,00,000*
10% Debentures	*10,00,000*
Trade payables	*55,00,000*
Fixed Assets	*70,00,000*
Investments	*45,00,000*
Current Assets	*68,00,000*
Loans & Advances	*22,00,000*

On the same day B Ltd. declared dividend at 20% and as agreed between both the companies fixed assets were to be depreciated @ 10% and investment to be taken at market value of ₹ 60,00,000. Calculate the Goodwill or Capital Reserve to be recorded in Consolidated Financial Statement.

Solution

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Fixed Assets	70,00,000	
Less: Value written off (70,00,000 x 10%)	(7,00,000)	63,00,000
Investments at Market value		60,00,000
Current Assets		68,00,000
Loans & Advances		22,00,000
Total Assets		2,13,00,000
Less: Total Liabilities: Trade payables	55,00,000	
10% Debentures	10,00,000	(65,00,000)
Equity		1,48,00,000
Majority Share in Equity (1,48,00,000 x 60%)		88,80,000

Less: Cost of Investment (10,00,000 x 60%) x 20	1,20,00,000	
Less: Dividend Received (6,00,000 x 2)	(12,00,000)	(1,08,00,000)
Goodwill		19,20,000

- Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.
- Goodwill and capital reserve of different subsidiaries can be adjusted to a net figure by the parent in consolidated financial statement.
- Goodwill of consolidated financial statement need not be written off to consolidated profit and loss account but test of impairment (Refer to AS 28) is made each time a consolidated financial statement is prepared.
- When share application money and allotment money is paid separately on different dates, then as per AS 21, date on which investment led to acquisition to control of subsidiary should be taken as date of investment, i.e., date of allotment.
- On the basis of above discussion, if control is gained in the subsidiary by a series of investments, then the date of the investment which led to holding-subsidiary relationship is taken into consideration and step by step calculations are made for each following investments.

Illustration 2

A Ltd. purchased 40% stake of B Ltd. for ₹ 12 per share. After two years A Ltd. decided to purchase another 40% share in B Ltd. B Ltd. has 1,00,00,000 equity shares of ₹ 10 each as fully paid up shares. The purchase deal was finalised on the following terms:

- *Purchase price per share to be calculated on the basis of average profit of last three years capitalised at 7.5%. Profits for last three years are ₹ 35 lacs, ₹ 65 lacs and ₹ 89 lacs.*
- *Total assets of B Ltd. of ₹ 11,50,00,000. Assets to be appreciated by ₹ 40,00,000.*
- *Of the External Trade payables for ₹ 2,50,00,000 one trade payable to whom ₹ 10,00,000 was due has expired and nothing is to be paid to settle this liability.*
- *B Ltd. will declare dividend @ 15%.*

Calculate the Goodwill or Capital Reserve for A Ltd. in Consolidated Financial Statement.

Solution

Calculation of Purchase Consideration

Particulars	₹
Profits for Last 3 years: First	89,00,000
Second	65,00,000
Third	35,00,000
Total profits for last 3 years	1,89,00,000
Average Profits (1,89,00,000/3)	63,00,000

Total value of B Ltd. (63,00,000/7.5%)	8,40,00,000
Number of Shares in B Ltd.	1,00,00,000
Value per Share	8.40
Purchase Consideration (1,00,00,000 x 40%) x 8.4	3,36,00,000

Calculation of Goodwill/Capital Reserve

Particulars	₹	₹
Fixed Assets	11,50,00,000	
Add: Appreciation in value of the asset	4,0,00,000	11,90,00,000
Less: Trade payables	2,50,00,000	
Less: Amount to be written off	(10,00,000)	(2,40,00,000)
Net Asset		9,50,00,000
Share in Net Asset (9,50,00,000 x 80%)		7,60,00,000
Less: Cost of Investment: Purchase Consideration	3,36,00,000	
Less: Dividend Received (10,00,00,000 x 40% x 15%)	(60,00,000)	
	2,76,00,000	
Add: Investment (1,00,00,000 x 40% x 12)	4,80,00,000	(7,56,00,000)
Capital Reserve		4,00,000

20.12 Minority Interest

- From the net income of the subsidiary, amount proportionate to minority interest is calculated and adjusted with the group income i.e. it is deducted from the profit & loss account balance and added to minority interest, so that the income of the group belonging to the parent is identified separately.
- Care should be taken to adjust for the cumulative preference dividend and profits belonging to the preference shares (if any) in the minority interest for the preference shares not held by the consolidated group. This adjustment should be made irrespective of whether or not dividends have been declared.
- Minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:
  - (i) The amount of equity attributable to minorities at the date on which investment in a subsidiary is made and
  - (ii) The minorities' share of movements in equity since the date the parent-subsidiary relationship came in existence.
- If carrying amount and cost of investment are different, carrying amount is considered for the purpose.

Illustration 3

Following are the Balance Sheet of A Ltd. and B Ltd.

	₹ '000			₹ '000	
Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Equity Shares	*6,000*	*5,000*	*Goodwill*	*100*	*20*
6% Preference shares	*-*	*1,000*	*Fixed Assets*	*3,850*	*2,750*
General Reserve	*1,200*	*800*	*Investment*	*1,620*	*1,100*
Profit & Loss Account	*1,020*	*1,790*	*Inventory*	*1,900*	*4,150*
Trade payables	*3,850*	*3,410*	*Trade receivables*	*4,600*	*4,080*
Dividend payable	*600*	*500*	*Cash & Bank*	*600*	*400*
	12,670	*12,500*		*12,670*	*12,500*

A Ltd. purchased 3/4th interest in B Ltd. at the beginning of the year at the premium of 25%. Following are the other information available:

a. *Profit & Loss Account of B Ltd. includes ₹ 1,000 thousands bought forward from the previous year.*

b. *The directors of both the companies have declared a dividend of 10% on equity share capital for the previous and current year.*

From the above information calculate Pre and Post Acquisition Profits, Minority Interest and Cost of Control.

Solution

Calculation of Pre and Post Acquisition Profits

Particulars	*Pre-acquisition Profits*	*(₹) Post-acquisition Profits*
Profit & Loss Account	10,00,000	7,90,000
General Reserve	800,000	-
	18,00,000	7,90,000
Less: Minority Interest (1800/4)	(4,50,000)	
(790/4)		(1,97,500)
Consolidated Balance Sheet	13,50,000	5,92,500

Calculation of Minority Interest

Particulars	*₹*
Paid up Equity Share Capital (50,00,000/4)	12,50,000
Paid up Preference Share Capital	10,00,000

Pre-acquisition Profits		4,50,000
Post-acquisition Profits		1,97,500
Minority Interest		28,97,500
Calculation of Goodwill/Capital Reserve		
Particulars	₹	₹
Cost of Investment in Subsidiary (50,00,000 x 75% x 125%)	46,87,500	
Less: Dividend Received (50,00,000 x 75% x 10%)	(3,75,000)	43,12,500
Less: Paid up Capital	37,50,000	
Pre-acquisition Profits	13,50,000	(51,00,000)
Capital Reserve		7,87,500

- The losses applicable to the minority are deducted from the minority interest unless minority interest is nil. Any further loss is adjusted with the consolidated group interest except to the extent that the minority has a binding obligation to, and can make the losses good. Subsequently, when the subsidiary makes profits, minority share in profits is added to majority share to the extent minority interest losses were absorbed by majority share.

  For example, 25% minority interest has the share in net equity ₹ 40 lacs and company made cumulative losses since the date of investment ₹ 200 lacs. 25% of ₹ 200 lacs i.e., ₹ 50 lacs is minority share in losses. Losses upto ₹ 40 lacs will be adjusted with the minority interest and further loss of ₹ 10 lacs will be adjusted with the majority interest. Hence in the Consolidated Balance Sheet for the relevant year, minority interest on the liabilities side will be NIL.

  In the next year, if subsidiary company makes a profit say, ₹ 60 lacs. Minority interest comes to ₹ 15 lacs, out of these 15 lacs, first ₹ 10 lacs will be added to majority interest as recovery of losses absorbed in past and balance ₹ 5 lacs will appear in Consolidated Balance Sheet as part of the Minority Interest.

20.13 Other Points

General rules: In order to present financial statements for the group in a consolidated format, the effect of transactions between group enterprises should be eliminated. AS 21 requires that intra-group transactions (including sales, expenses and dividends) and the resulting unrealised profits and losses be eliminated in full.

Liabilities due to one group enterprise by another will be set off against the corresponding asset in the other group enterprise's financial statements; sales made by one group enterprise to another should be excluded both from turnover and from cost of sales or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying enterprise has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent

that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets reduced to cost to the group.

For transactions between group enterprises, unrealised profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and tangible fixed assets, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

Unrealised profit in inventories: Where a group enterprise sells goods to another, the selling enterprise, as a separate legal enterprise, records profits made on those sales. If these goods are still held in inventory by the buying enterprise at the year end, however, the profit recorded by the selling enterprise, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealised profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

When the goods are sold by a parent to a subsidiary (downstream transaction), all of the profit on the transaction is eliminated, irrespective of the percentage of the shares held by the parent. In other words, the group is not permitted to take credit for the share of profit that is attributable to any minority.

Where the goods are sold by a subsidiary, in which there is a minority interest, to another group enterprise (upstream transaction), the whole of the unrealised profit should also be eliminated.

Unrealised profit on transfer or non-current assets

- Similar to the treatment described above for unrealised profits in inventories, unrealised inter-company profits arising from intra-group transfers of fixed assets are also eliminated from the consolidated financial statements. Intra Group Transactions: The effect of any unrealised profits from intra-group transactions should be eliminated from consolidated financial statement. Effect of losses from intra-group transactions need not be eliminated only when the cost is not recoverable.

  For example, A Ltd. sold goods for ₹ 1,25,000 to B Ltd., another subsidiary under same group at the gross profit of 20% on sales. On the date of consolidated balance sheet, B Ltd. has goods worth ₹ 25,000 as inventory from the same consignment. The unrealised profits of ₹ 5,000 (25,0000 x 20%) will be deducted from the closing inventory and it will be valued as ₹ 20,000 i.e. at cost to A Ltd. for the purpose of Consolidated Financial Statement.

- Reporting Date: For the purposes of preparing consolidated financial statements, the financial statements of all subsidiaries should, wherever practicable, be prepared:
  - To the same reporting date; and
  - For the same reporting period as of the parent.

- If practically it is not possible to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the parent, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements. In any case, the difference between reporting dates should not be more than six months.
- Accounting Policies: Accounting policies followed in the preparation of the financial statements of the parent, subsidiaries and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

  If accounting policies followed by different companies in the group are not uniform, then adjustments should be made in the items of the subsidiaries to bring them in line with the accounting policy of the parent. Here we will not disturb the figures or policies in respective books, but while including the items in consolidated financial statement, adequate adjustments will be made.

  For example, parent company A Ltd. is valuing the inventory on weighted average basis and its inventory is valued as ₹ 100 lacs but its subsidiary B Ltd. is following FIFO method and its inventory is valued at ₹ 20 Lacs. Inventory of B Ltd. will be valued under weighted average method say, ₹ 25 lacs. Now for the purpose of consolidated financial statement, inventory of B Ltd. will be taken as ₹ 25 lacs and the inventory disclosed in consolidated trading account on credit side and in consolidated balance sheet assets side will be ₹ 125 lacs. Hence adequate adjustments are made for this ₹ 5 lac in consolidated financial statement.

  If it is not practical to make such adjustments for uniform accounting policies in preparing the consolidated financial statements, then the fact should be disclosed together with the amounts of each items in the consolidated financial statement to which the different accounting policies have been applied.

  Let us take above example, in case it is not possible practically to adjust ₹ 5 lacs in the inventory of B Ltd. for the purpose of consolidated financial statement, then item will be disclosed in Consolidated Trading Account (Credit Side) and Consolidated Balance Sheet (Asset Side) as follow:

Closing Inventory of A Ltd. (Weighted Average Method)	100 lacs	
Closing Inventory of B Ltd. (FIFO Method)	20 lacs	120 lacs

20.14 Disposal of Holding

The results of operations of a subsidiary are included in the consolidated financial statement as from the date on which parent-subsidiary relationship comes into existence and are included in the consolidated statement of profit and loss until the date of cessation of the relationship. On disposal of the investment, consolidated profit and loss account will include the transactions till the date the parent-subsidiary relationship ceases to exist. The difference between the proceeds from the disposal of investment and the parent's share in the net asset of the subsidiary on the basis of the carrying amount, on the date of disposal is recorded in the consolidated profit and

loss account. While calculating the share of parent in the net asset of the subsidiary on the date of disposal, adjustment is made for the minority interest calculated as above.

In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.

Investment in the subsidiary, in the separate financial statement of the parent is recorded according to the provisions of AS 13.

Illustration 4

A Ltd. had acquired 80% share in the B Ltd. for ₹ 25 lacs. The net assets of B Ltd. on the day are ₹ 22 lacs. During the year A Ltd. sold the investment for ₹ 30 lacs and net assets of B Ltd. on the date of disposal was ₹ 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

Solution

Calculation of Profit/Loss on disposal of investment in subsidiary

Particulars	₹	₹
Net Assets of B Ltd. on the date of disposal		35,00,000
Less: Minority Interest (35 lacs x 20%)		(7,00,000)
A Ltd.'s Share in Net Assets		28,00,000
Proceeds from the sale of Investment		30,00,000
Less: A Ltd.'s share in net assets		(28,00,000)
		2,00,000
Less: Goodwill in the Consolidated Financial Statement		
Cost of investment	25,00,000	
Less: A Ltd.'s Share in net asset on the date (22 lacs x 80%)	(17,60,000)	(7,40,000)
Loss on sale of investment		5,40,000

Illustration 5

A Ltd. had acquired 80% share in the B Ltd. for ₹ 15 lacs. The net assets of B Ltd. on the day are ₹ 22 lacs. During the year A Ltd. sold the investment for ₹ 30 lacs and net assets of B Ltd. on the date of disposal was ₹ 35 lacs. Calculate the profit or loss on disposal of this investment to be recognised in consolidated financial statement.

Solution

Calculation of Profit/Loss on disposal of investment in subsidiary

Particulars	₹	₹
Net Assets of B Ltd. on the date of disposal		35,00,000
Less: Minority Interest (35 lacs x 20%)		(7,00,000)
A Ltd.'s Share in Net Assets		28,00,000
Proceeds from the sale of Investment		30,00,000
Less: A Ltd.'s share in net assets		28,00,000
		2,00,000
Add:: Capital Reserve in the Consolidated Financial Statement		
A Ltd.'s Share in net asset on the date (22 lacs x 80%)	17,60,000	
Less: Cost of investment	(15,00,000)	2,60,000
Profit on sale of investment		4,60,000

20.15 Disclosure

In addition to disclosures required by paragraph 11 and 20, following disclosures should be made:

a. In the consolidated financial statement, a list of all subsidiaries including the name, country of incorporation or residence, proportion of ownership interest and, if different, proportion of voting power held;

b. In consolidated financial statements, where applicable:

   (i) The nature of the relationship between the parent and a subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than one-half of the voting power of the subsidiary;

   (ii) The effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period; and

   (iii) The names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and the difference in reporting dates.

20.16 Transitional Provisions

On the first occasion that consolidated financial statements are presented, comparative figures for the previous period need not be presented. In all subsequent years full comparative figures for the previous period should be presented in the consolidated financial statements.

20.17 Accounting for Taxes on Income in the Consolidated Financial Statements

While preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements should be the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

The amounts of tax expense appearing in the separate financial statements of a parent and its subsidiaries do not require any adjustment for the purpose of consolidated financial statements. In view of this, while preparing consolidated financial statements, the tax expense to be shown in the consolidated financial statements is the aggregate of the amounts of tax expense appearing in the separate financial statements of the parent and its subsidiaries.

Reference: The students are advised to refer the full text of AS 21 "Consolidated Financial Statements" (issued 2001).

UNIT 21 : AS 22: ACCOUNTING FOR TAXES ON INCOME

21.1 Introduction

AS 22 was issued in 2001 and is mandatory in nature for:

a. All the accounting periods commenced on or after 01.04.2001, 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 the enterprises of a group, if the parent presents consolidated financial statements and the Accounting Standard is mandatory in nature in respect of any of the enterprises of that group in terms of (i) above.

b. All the accounting periods commenced on or after 01.04.2002, in respect of companies not covered by (a) above.

c. All the accounting periods commenced on or after 01.04.2003, in respect of all other enterprises.

This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

21.2 Need

Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons.

Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes, known as Permanent Difference.

Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and the corresponding amount which is recognised for the computation of taxable income, known as Time Difference.

21.3 Definitions

Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income-tax expense or adding income tax saving.

Taxable income (tax loss) is the amount of the income (loss) for a period, determined in

accordance with the tax laws, based upon which income-tax payable (recoverable) is determined.

Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

Current tax is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

Deferred tax is the tax effect of timing differences.

The differences between taxable income and accounting income can be classified into permanent differences and timing differences.

Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently.

21.4 Recognition

Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

Permanent differences do not result in deferred tax assets or deferred tax liabilities. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet.

While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation. This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

21.5 Re-assessment of Unrecognised Deferred Tax Assets

At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realised.

21.6 Measurement

Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws. Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws. Deferred tax assets and liabilities should not be discounted to their present value.

21.7 Review of Deferred Tax Assets

The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

21.8 Disclosure

Statement of profit and loss

Under AS 22, there is no specific requirement to disclose current tax and deferred tax in the statement of profit and loss. However, under company law requirements, the amount of Indian income tax and other Indian taxation on profits, including, wherever practicable, with Indian income tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income tax and distinguishing, wherever practicable, between income tax and other taxation should be disclosed.

AS 22 does not require any reconciliation between accounting profit and the tax expense.

Balance sheet

The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts.

Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities. The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balances should be disclosed in the notes to accounts.

The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

An enterprise should offset assets and liabilities representing current tax if the enterprise:

a. Has a legally enforceable right to set off the recognised amounts and

b. Intends to settle the asset and the liability on a net basis.

An enterprise should offset deferred tax assets and deferred tax liabilities if:

a. The enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

b. The deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

21.9 Transitional Provision

On the first occasion that the taxes on income are accounted for in accordance with this Statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this Statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets (see paragraphs 15-18). The amount so credited/charged to the revenue reserves should be the same as that which would have resulted if this Statement had been in effect from the beginning.

The Background material on AS 22 further clarifies that in case an enterprise does not have adequate revenue reserves to adjust the accumulated balance of deferred tax liability, it should be adjusted to the extent not adjusted against revenue reserves, against opening balance of profit and loss account. Where the opening balance of profit and loss is also inadequate, it should be shown, to the extent not adjusted, as 'Debit balance in Profit and Loss Account' on the asset side of the balance sheet. The accumulated deferred tax liability cannot be adjusted against securities premium.

21.10 Relevant Explanations to AS 22

Accounting for Taxes on Income in the situations of Tax Holiday under sections 80-IA and 80-IB of the Income Tax Act, 1961

The deferred tax in respect of timing differences which reverse during the tax holiday period should not be recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of the Act. Deferred tax in respect of timing differences which reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the situations of Tax Holiday under sections 10A and 10B of the Income Tax Act, 1961

The deferred tax in respect of timing differences which originate during the tax holiday period

and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the context of section 115JB of the Income Tax Act, 1961

The payment of tax under section 115JB of the Act is a current tax for the period. In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act. In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act.

Virtual certainty supported by convincing evidence

Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement and will have to be evaluated on a case to case basis. Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain. Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and it should be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

21.11 Miscellaneous Illustrations

Illustration 1

From the following details of A Ltd. for the year ended 31-03-2017, calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Particulars	*₹*
Accounting Profit	*6,00,000*
Book Profit as per MAT	*3,50,000*

Profit as per Income Tax Act	*60,000*
Tax rate	*20%*
MAT rate	*7.50%*

Solution

Tax as per accounting profit 6,00,000×20%= ₹ 1,20,000

Tax as per Income-tax Profit 60,000×20% =₹ 12,000

Tax as per MAT 3,50,000×7.50%= ₹ 26,250

Tax expense= Current Tax +Deferred Tax

₹ 1,20,000 = ₹ 12,000+ Deferred tax

Therefore, Deferred Tax liability as on 31-03-201

= ₹ 1,20,000 – ₹ 12,000 = ₹ 1,08,000

Amount of tax to be debited in Profit and Loss account for the year 31-03-2017

Current Tax + Deferred Tax liability + Excess of MAT over current tax

= ₹ 12,000 + ₹ 1,08,000 + ₹ 14,250

= ₹ 1,34,250

Illustration 2

Ultra Ltd. has provided the following information.

Depreciation as per accounting records =₹ 2,00,000

Depreciation as per tax records =₹ 5,00,000

Unamortised preliminary expenses as per tax record = ₹ 30,000

There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment when the tax rate is 50%?

Solution

Calculation of difference between taxable income and accounting income

Particulars	*Amount (₹)*
Excess depreciation as per tax ₹ (5,00,000 – 2,00,000)	3,00,000
Less: Expenses provided in taxable income	(30,000)
Timing difference	2,70,000

Tax expense is more than the current tax due to timing difference.

Therefore deferred tax liability = 50% x 2,70,000 = ₹ 1,35,000

Illustration 3

XYZ is an export oriented unit and was enjoying tax holiday upto 31.3.2016. No provision for deferred tax liability was made in accounts for the year ended 31.3.2016. While finalising the accounts for the year ended 31.3.2017, the Accountant says that the entire deferred tax liability upto 31.3.2016 and

current year deferred tax liability should be routed through Profit and Loss Account as the relevant Accounting Standard has already become mandatory from 1.4.2001. Do you agree?

Solution

Paragraph 33 of AS 22 on "Accounting for Taxes on Income" relates to the transitional provisions. It says, "On the first occasion that the taxes on income are accounted for in accordance with this statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets.

Further Paragraph 34 lays down, "For the purpose of determining accumulated deferred tax in the period in which this statement is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are compared and the differences, if any, are determined. The tax effects of these differences, if any, should be recognised as deferred tax assets or liabilities, if these differences are timing differences."

Therefore, in the case of XYZ, even though AS 22 has come into effect from 1.4.2001, the transitional provisions permit adjustment of deferred tax liability/asset upto the previous year to be adjusted from opening reserve. In other words, the deferred taxes not provided for alone can be adjusted against opening reserves.

Provision for deferred tax asset/liability for the current year should be routed through profit and loss account like normal provision.

Illustration 4

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of ₹ 2,00,000 for the year ending 31.3.2015. For the years ending 31.3.2016 and 31.3.2017, it made profits of ₹ 1,00,000 and ₹ 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.2015, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 2016 and 2017 for tax purposes. Prepare a statement of Profit and Loss for the years ending 2015, 2016 and 2017.

Solution

Statement of Profit and Loss

	31.3.2015 ₹	*31.3.2016* ₹	*31.3.2017* ₹
Profit (Loss)	(2,00,000)	1,00,000	1,20,000
Less: Current tax			(8,000)
Deferred tax:			
Tax effect of timing differences originating during the year	80,000		
Tax effect of timing differences reversed/adjusted during the year		(40,000)	(40,000)
Profit (Loss) After Tax Effect	(1,20,000)	60,000	72,000

Illustration 5

The following particulars are stated in the Balance Sheet of M/s Exe Ltd. as on 31.03.2016:

	(₹ in lakhs)
Deferred Tax Liability (Cr.)	*20.00*
Deferred Tax Assets (Dr.)	*10.00*

The following transactions were reported during the year 2016-2017:

(i)	*Tax Rate*	*50%*
(ii)	*Depreciation – as per Books*	*50.00*
	Depreciation – for Tax purposes	*30.00*
	There were no additions to Fixed Assets during the year.	
(iii)	*Items disallowed in 2015-2016 and allowed for Tax purposes in 2016-2017*	*10.00*
(iv)	*Interest to Financial Institutions accounted in the Books on accrual basis, but actual payment was made on 30.09.2017*	*20.00*
(v)	*Donations to Private Trusts made in 2016-2017*	*10.00*
(vi)	*Share issue expenses allowed under 35(D) of the I.T. Act, 1961 for the year 2016-2017 (1/10th of ₹ 50.00 lakhs incurred in 2015-2016)*	*5.00*
(vii)	*Repairs to Plant and Machinery ₹ 100.00 lakhs was spread over the period 2016-2017 and 2017-2018 equally in the books. However, the entire expenditure was allowed for Income-tax purposes.*	

Indicate clearly the impact of above items in terms of Deferred Tax liability/Deferred Tax Assets and the balances of Deferred Tax Liability/Deferred Tax Asset as on 31.03.2017.

Solution

Impact of various items in terms of deferred tax liability/deferred tax asset

Transactions	*Analysis*	*Nature of difference*	*Effect*	*Amount*
Difference in depreciation	Generally, written down value method of depreciation is adopted under IT Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years.	Responding timing difference	Reversal of DTL	₹ 20 lakhs × 50% = ₹ 10 lakhs
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Responding timing difference	Reversal of DTA	₹ 10 lakhs × 50% = ₹ 5 lakhs

Interest to financial institutions	It is allowed as deduction under section 43B of the IT Act, if the payment is made before the due date of filing the return of income (i.e. 31st October, 2017).	No timing difference	Not applicable	Not applicable
Donation to private trusts	Not an allowable expenditure under IT Act.	Permanent difference	Not applicable	Not applicable
Share issue expenses	Due to disallowance of full expenditure under IT Act, tax payable in the earlier years was higher.	Responding timing difference	Reversal of DTA	₹ 5 lakhs × 50% = ₹ 2.5 lakhs
Repairs to plant and machinery	Due to allowance of full expenditure under IT Act, tax payable of the current year will be less.	Originating timing difference	Increase in DTL	₹ 50 lakhs × 50% = ₹ 25 lakhs

Deferred Tax Liability Account

		₹ *in lakhs*			₹ *in lakhs*
31.3.2017	To Profit and Loss account (Depreciation)	10.00	1.4.2016	By Balance b/d	20.00
	To Balance c/d	35.00		By Profit and Loss Account (Repairs to plant)	25.00
		45.00			45.00
			1.4.2017	By Balance b/d	35.00

Deferred Tax Asset Account

		₹ *in lakhs*			₹ *in lakhs*
1.4.2016	To Balance b/d	10.00	31.3.2017	By Profit and Loss Account: Items disallowed in 2015-2016 and allowed as per I.T. Act in 2016-2017	5.00
				By Share issue expenses	2.50
				By Balance c/d	2.50
		10.00			10.00
1.4.2017	To Balance b/d	2.50			

Reference: The students are advised to refer the full text of AS 22 "Accounting for Taxes on Income" (issued 2001).

UNIT 22 : AS 23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

22.1 Introduction

AS 23, came into effect in respect of accounting periods commenced on or after 1-4-2002. AS 23 describes the principles and procedures for recognizing investments in associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in the consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable.

22.2 Objective

The objective of this Standard is to lay down principles and procedures for recognizing the investments in associates and its effect on the financial operations of the group in the consolidated financial statement. Reference to AS 23 is compulsory for the companies following AS 21 and preparing consolidated financial statement for their group. For disclosing investment in associates in the separate financial statement of the investor itself, one should follow AS 13.

22.3 Definitions of the terms used in the Accounting Standard

A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent). A **parent** is an enterprise that has one or more subsidiaries.

A **group** is a parent and all its subsidiaries.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities. **Consolidated financial statements** are the financial statements of a group presented as those of a single enterprise.

An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Significant influence is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies. This definition excludes the subsidiaries or joint venture from the scope of an associate but apart from these any other enterprises, which are significantly influenced by the investor, is an associate for the purpose of this standard. Any enterprise having 20% or more control over voting power or any interest directly or indirectly in any other enterprise will be assumed to have significantly influencing the other enterprise unless proved otherwise. Similarly any enterprise that does not have 20% or more control then it is assumed not having significant influence on the enterprise unless proved otherwise.

An enterprise can influence the significant economic decision making by many ways like:

- Having some voting power.

- Representation on the board of directors or governing body of the investee.
- Participation in policy-making processes.
- Interchange of managerial personnel.
- Provision of essential technical information.
- Influencing inter-company transactions i.e. sale of goods and services, sharing technical knowledge etc.

As a general rule, significant influence is presumed to exist when an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee.

As with the classification of any investment, the substance of the arrangement in each case should be considered. If it can be clearly demonstrated that an investor holding 20% or more of the voting power of the investee does not have significant influence, the investment will not be accounted for as an associate.

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

If the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. The presence of one or more of the indicators as above may indicate that an investor has significant influence over a less than 20% owned corporate investee.

Control exists when parent company has either:

a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise.

b. Or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from subsidiary company's activities.

   If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

   An enterprise is considered to control the composition of the board of directors of a company or governing body in case of an enterprise other than a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body. An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

   (i) A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or

(ii) A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or

(iii) The director/member is nominated by that enterprise or a subsidiary thereof.

To understand the above definitions let us take few examples:

Example1: A Ltd. has 70% holding in C Ltd. and B Ltd. also has 28% holding in the same company. So, A Ltd. with the majority holding i.e. more than 50% is the parent company i.e. a holding company and B Ltd. with more than 20% share though minor is a business associate.

Example 2: A Ltd. holding 90% share in B Ltd. and 10% in C Ltd., and also B Ltd. holding 11% shares in C Ltd. In this case, A Ltd. is parent of B Ltd. but due to total of direct and indirect holding of (10 + 11) 21% in C Ltd., C Ltd. is an associate of A Ltd. Though for consolidated financial statement purpose, these holding will be 19.9% (10% + 90% of 11%), as rest 1.1% belongs to minority interest.

22.4 Associates Accounted for using the Equity method

The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

From the definition, following broad conclusions can be drawn:

a. In CFS, investment is to be recorded at cost.

b. Any surplus or deficit in cost and net asset to be recorded as goodwill or capital reserve.

c. Distributions received from an investee reduce the carrying amount of the investment.

d. Any subsequent change in share in net asset is adjusted in cost of investment and goodwill/capital reserve.

e. Consolidated Profit & Loss shows the investor's share in the results of operations of the investee.

Illustration 1

A Ltd. acquire 45% of B Ltd. shares on April 01, 2016, the price paid was ₹ 15,00,000. Following are the extract of balance sheet of B Ltd.:

Paid up Equity Share Capital	*₹ 10,00,000*
Securities Premium	*₹ 1,00,000*
Reserve & Surplus	*₹ 5,00,000*

B Ltd. has reported net profits of ₹ 3,00,000 and paid dividends of ₹ 1,00,000. Calculate the amount at which the investment in B Ltd. should be shown in the consolidated balance sheet of A Ltd. as on March 31, 2017.

Solution

Calculation of the carrying amount of Investment as per equity method

Particulars	₹	₹
Equity Shares	10,00,000	
Security Premium	1,00,000	
Reserves & Surplus	5,00,000	
Net Assets	16,00,000	
45% of Net Asset	7,20,000	
Add: 45% of Profits for the year	1,35,000	
	8,55,000	
Less: Dividend Received	45,000	8,10,000
Less: Cost of Investment		(15,00,000)
Goodwill		6,90,000

Consolidated Balance Sheet (Extract)

Assets	₹	₹
Investment in B Ltd.	810,000	
Add: Goodwill	690,000	1,500,000

22.5 Circumstances under which Equity Method is followed

Equity method of accounting is to be followed by all the enterprises having significant influence on their associates except in the following cases:

a. Control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

b. The term 'Near Future' is explained with AS 21.

   Or it operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor.

   In both the above cases, investment of investor in the share of the investee is treated as investment according to AS 13.

An investor should discontinue the use of the equity method from the date that:

a. It ceases to have significant influence in an associate but retains, either in whole or in part, its investment.

b. The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates

should be accounted for in accordance with AS 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.

22.6 Application of the Equity Method

- Many of the rules followed under equity method for an associate is similar to consolidated financial statement rules as in case of subsidiary i.e. AS 21.
- Investment in an associate should be recorded as equity from the date when such relation comes in effect.
- Investment in the associate is recorded at cost and any difference in the cost and investor's share in equity on the date of acquisition is shown as goodwill or capital reserve.

  Case 1: A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment ₹ 33,000 and Total Equity on the date of acquisition ₹ 2,00,000.

A Ltd.'s share in equity (2,00,000 x 22%)	₹ 44,000
Less: Cost of Investment	₹ (33,000)
Capital Reserve	₹ 11,000

Extract of Balance Sheet

Assets	₹	₹
Investment in B Ltd.	44,000	
Less: Capital reserve	(11,000)	33,000

  Case 2: A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment ₹ 55,000 and Total Equity on the date of acquisition ₹ 2,00,000.

Cost of Investment	₹ 55,000
Less: A Ltd.'s share in equity (2,00,000 x 22%)	₹ 44,000
Goodwill	₹ 11,000

Extract of Balance Sheet

Assets	₹	₹
Investment in B Ltd.	44,000	
Add: Goodwill	11,000	55,000

- An enterprise having share of profits of more than 50% in other company, they are said to be in Parent-Subsidiary relationship. However, if the share in profits is more than 20% but upto 50% then this relationship is termed as associate relationship. This stake of 20% can be acquired either in one go or in more than one transaction. This share of stake can be increased further say from 25% to 30%. Adjustment should be made with each transaction.

Case 1: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 during the same year. Other information is as follow:

Cost of Investment for 10% ₹ 1,00,000 and for 15% ₹ 1,45,000

Net asset on April 01st ₹ 8,50,000 and on October 01 ₹ 10,00,000.

Calculations for April 01:

Cost of investment	₹ 1,00,000
10% share in net asset	₹ 85,000
Goodwill	₹ 15,000

Calculations for October 01:

15% share in net asset	₹ 1,50,000
Cost of investment	₹ 1,45,000
Capital Reserve	₹ 5,000
Total goodwill (15,000 – 5,000)	₹ 10,000

Case 2: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 of the same year. Other information is as follow:

Cost of Investment for 10% ₹ 1,00,000 and for 15% ₹ 1,55,000

Net asset on April 01st ₹ 8,50,000 and on October 01st ₹ 10,00,000.

Calculations for April 01:

Cost of investment	₹ 1,00,000
10% share in net asset	₹ 85,000
Goodwill	₹ 15,000

Calculations for October 01:

Cost of investment	₹ 1,55,000
15% share in net asset	₹ 1,50,000
Goodwill	₹ 5,000
Total goodwill (15,000 + 5,000)	₹ 20,000

Case 3: A Ltd. acquired 25% stake of B Ltd. on April 01 and further 5% on October 01 of the same year. Other information is as follow:

Cost of Investment for 25% ₹ 1,50,000 and for 5% ₹ 20,000

Net asset on April 01st ₹ 5,00,000.

Profit for the year ₹ 90,000 earned in the ratio 2:1 respectively.

Calculations for April 01:

Cost of investment	₹ 1,50,000
25% share in net asset	₹ 1,25,000
Goodwill	₹ 25,000

Calculations for October 01:

Profits for the first half (90,000/3) x 2	₹ 60,000
Additional share of A Ltd.	5%
Pre-acquisition profits i.e. capital reserve (60,000 x 5%)	₹ 3,000
5% share in net asset	₹ 25,000
Cost of investment	₹ 20,000
Capital Reserve	₹ 5,000
Cost of Investment on April 01st	₹ 1,50,000
Less: Goodwill	₹ 25,000
Carrying Amount on April 01st	₹ 1,25,000
Add: Additional Share in Net Asset on October 01st	₹ 25,000
Add: Capital share of Profits for first half	₹ 3,000
Add: Revenue shares of Profits for first half (60,000 x 25%)	₹ 15,000
Add: Revenue shares of Profits for second half (30,000 x 30%)	₹ 9,000
Total Carrying Amount on March 31st	₹ 1,77,000

- If there is any transaction between the Investor Company and investee concern then the unrealised profits on such goods to the extent of investor's share should be eliminated from consolidated financial statement. As in the above example, the profits calculated on the goods lying with the buyer on the date of statement, will be eliminated to the extent of investor's share i.e. 22%.
- Any loss on such transactions are not eliminated to the extent that such loss is not recoverable. Otherwise such losses are written off from consolidated financial statement fully.

Illustration 2

A Ltd. acquired 40% share in B Ltd. on April 01, 2014 for ₹ 10 lacs. On that date B Ltd. had 1,00,000 equity shares of ₹ 10 each fully paid and accumulated profits of ₹ 2,00,000. During the year 2014-2015, B Ltd. suffered a loss of ₹ 10,00,000; during 2015-2016 loss of ₹ 12,50,000 and during 2016-2017 again a loss of ₹ 5,00,000. Show the extract of consolidated balance sheet of A Ltd. on all the four dates recording the above events.

Solution

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	₹
Equity Shares	10,00,000
Reserves & Surplus	2,00,000
Net Assets	12,00,000
40% of Net Asset	4,80,000
Less: Cost of Investment	(10,00,000)
Goodwill	5,20,000

Consolidated Balance Sheet (Extract) as on April 01, 2014

Assets	₹	₹
Investment in B Ltd.	4,80,000	
Add: Goodwill	5,20,000	10,00,000

Calculation of Carrying Amount of Investment in the year ended on 2014-2015

Particulars	₹
Investment in B Ltd.	4,80,000
Add: Goodwill	5,20,000
Cost of Investment	10,00,000
Less: Loss for the year (10,00,000 x 40%)	(4,00,000)
Carrying Amount of Investment	6,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2015

Assets	₹	₹
Investment in B Ltd.	80,000	
Add: Goodwill	5,20,000	6,00,000

Calculation of Carrying Amount of Investment in the year ended on 2015-2016

Particulars	₹
Carrying Amount of Investment	6,00,000
Less: Loss for the year (12,50,000 x 40%)	(5,00,000)
Carrying Amount of Investment	1,00,000

Consolidated Balance Sheet (Extract) as on March 31, 2016

Assets	₹	₹
Investment in B Ltd.	-	
Add: Goodwill	1,00,000	1,00,000

Calculation of Carrying Amount of Investment in the year ended on 2016-2017

Particulars	₹
Carrying Amount of Investment	1,00,000
Less: Loss for the year (5,00,000 x 40%)	(2,00,000)
Carrying Amount of Investment	(1,00,000)

Consolidated Balance Sheet (Extract) as on March 31, 2017

Assets	₹	₹
Investment in B Ltd.		-

- As far as possible the reporting date of the financial statements should be same for consolidated financial statement. If practically it is not possible to draw up the financial statements of one or more enterprise to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the investor, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the consolidated financial statements. In any case, the difference between reporting dates of the concern and consolidated financial statement should not be more than six months.
- Accounting policies followed in the preparation of the financial statements of the investor, investee and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

  If accounting policies followed by different enterprises in the group are not uniform, then adjustments should be made in the items of the individual financial statements to bring it in line with the accounting policy of the consolidated statement.

The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

22.7 Contingencies

In accordance with AS 4, the investor discloses in the consolidated financial statements:

a. Its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and

b. Those contingencies that arise because the investor is severally liable for the liabilities of the associate.

22.8 Disclosure

- In addition to the disclosures required above, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.

- Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.
- The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.
- In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.
- If an associate is not accounted for using the equity method the reasons for not doing the same.
- Goodwill/capital reserve arising on the acquisition of an associate by an investor should be disclosed separately though it is included in the carrying amount of the investment.

22.9 Transitional Provisions

On the first occasion when investment in an associate is accounted for in consolidated financial statements in accordance with this Statement, the carrying amount of investment in the associate should be brought to the amount that would have resulted had the equity method of accounting been followed as per this Statement since the acquisition of the associate. The corresponding adjustment in this regard should be made in the retained earnings in the consolidated financial statements.

22.10 Relevant Explanations to AS 23

Treatment of Proposed Dividend in Associates in Consolidated Financial Statements:

In case an associate has made a provision for proposed dividend in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

Consideration of Potential Equity Shares for Determining whether an Investee is an Associate, Accounting for Investments in Associates in Consolidated Financial Statements:

The potential equity shares of the investee held by the investor should not be taken into account for determining the voting power of the investor.

Reference: The students are advised to refer the full text of AS 23 "Accounting for Investments in Associates in Consolidated Financial Statements" (issued 2001).

UNIT 23 : AS 24: DISCONTINUING OPERATIONS

23.1 Introduction

AS 24, is mandatory in nature in respect of accounting periods commenced on or after 1-4-2004 for 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.

In respect of all other enterprises, the Accounting Standard would be mandatory in nature in respect of accounting periods commenced on or after 1-4-2005. Earlier application of the accounting standard would be encouraged.

This standard is applicable to all discontinuing operations, representing separate major line of business or geographical area of operations of an enterprise.

23.2 Objective

The objective of this Statement is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

23.3 Discontinuing Operation

A discontinuing operation is a component of an enterprise:

a. That the enterprise, pursuant to a single plan, is:

   (i) Disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders or

   (ii) Disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually or

   (iii) Terminating through abandonment and

b. That represents a separate major line of business or geographical area of operations.

c. That can be distinguished operationally and for financial reporting purposes.

A reportable business segment or geographical segment as defined in AS 17 'Segment

Reporting', would normally satisfy criterion (b) of the above definition, that is, it would represent a separate major line of business or geographical area of operations. A part or such a segment may also satisfy criterion (b) of the above definition. For an enterprise that operates in a single business or geographical segment and, therefore, does not report segment information, a major product or service line may also satisfy the criteria of the definition.

The sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single coordinated plan.

An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not abandonment because that operation, although changed, is continuing.

Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

a. Gradual or evolutionary phasing out of a product line or class of service.

b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.

c. Shifting of some production or marketing activities for a particular line of business from one location to another and

d. Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

a. The operating assets and liabilities of the component can be directly attributed to it.

b. Its revenue can be directly attributed to it.

c. At least a majority of its operating expenses can be directly attributed to it.

Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it. Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.

23.4 Initial Disclosure Event

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

a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation or

b. The enterprise's board of directors or similar governing body has both

   (i) approved a detailed, formal plan for the discontinuance and

   (ii) made an announcement of the plan.

a detailed, formal plan for the discontinuance normally includes:

- identification of the major assets to be disposed of;
- the expected method of disposal;
- the period expected to be required for completion of the disposal;
- the principal locations affected;
- the location, function, and approximate number or employees who will be compensated for terminating their services; and
- the estimated proceeds or salvage to be realised by disposal.

An enterprise's board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, trade payables, trade unions, etc. in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

23.5 Recognition and Measurement

For recognizing and measuring the effect of discontinuing operations, this AS does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

23.6 Presentation and Disclosure

23.6.1 Initial Disclosure

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

a. A description of the discontinuing operation(s).

b. The business or geographical segment(s) in which it is reported as per AS 17.

c. The date and nature of the initial disclosure event.

d. The date or period in which the discontinuance is expected to be completed if known or determinable.

e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled.

f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period.

g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

h. The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

23.6.2 Disclosures other than Initial Disclosures Note

All the disclosures above should be presented in the notes to the financial statements except for amounts pertaining to pre-tax profit/loss of the discontinuing operation and the income tax expense thereon (second last bullet above) which should be shown on the face of the statement of profit and loss.

Disclosures as required by AS 4 'Contingencies and Events Occurring After the Balance Sheet Date', are made if an initial disclosure event occurs between the balance sheet date and the date on which the financial statements for that period are approved by the board of directors in the case of a company or by the corresponding approving authority in the case of any other enterprise.

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and

b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes. The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received. If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed. Any

disclosures required by this Statement should be presented separately for each discontinuing operation.

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

a. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto and

b. The amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

Disclosures in an interim financial report in respect of a discontinuing operation should be made in accordance with AS 25, 'Interim Financial Reporting', including:

a. Any significant activities or events since the end of the most recent annual reporting period relating to a discontinuing operation and

b. Any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled.

Reference: The students are advised to refer the full text of AS 24 "Discontinuing Operations"

UNIT 24 : AS 25: INTERIM FINANCIAL REPORTING

24.1 Introduction

AS 25 does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Standard. The standard prescribes the minimum contents of an interim financial report and requires that an enterprise which elects to prepare and present an interim financial report, should comply with this standard. It also lays down the principles for recognition and measurement in a complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, trade payables and others to understand an enterprise's capacity to generate earnings and cash flows, its financial condition and liquidity.

A statute governing an enterprise or a regulator may also require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Standard. In such a case, the recognition and measurement principles as laid down in this Standard are applied in respect of such information, unless otherwise specified in the statute or by the regulator.

24.2 Definitions of the terms used under the Accounting Standard

Interim period is a financial reporting period shorter than a full financial year.

Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.

During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period.

24.3 Content of an Interim Financial Report

A complete set of financial statements normally includes Balance sheet, Statement of Profit & Loss, Cash flow statement and Notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

The benefit of timeliness of presentation may be partially offset by a reduction in detail in the information provided. Therefore, this Standard requires preparation and presentation of an interim financial report containing, as a minimum, a set of condensed financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported. AS 25 does not prohibit or discourage an enterprise from presenting a complete set of financial statements in its interim financial report, rather than a set of condensed financial statements. The recognition and measurement principles set out in this Standard apply also to complete financial statements for an interim period, and such statements

would include all disclosures required by this Standard as well as those required by other Accounting Standards. Minimum components of an Interim Financial Report includes condensed Financial Statement.

24.4 Form and Content of Interim Financial Statements

If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.

If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement.

Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.

If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with AS 20 then it has to present basic and diluted earnings per share as per AS 20 on the face of Statement of Profit and Loss complete or condenses for an interim period also.

24.5 Selected Explanatory Notes

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

a. A statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change.

b. Explanatory comments about the seasonality of interim operations.

c. The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that is unusual because of their nature, size, or incidence as per AS 5.

d. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period.

e. Issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares.

f. Dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares.

g. Segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms

of AS 17, Segment Reporting, to disclose segment information in its annual financial statements).

h. The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations and

i. Material changes in contingent liabilities since the last annual balance sheet date.

The above information should normally be reported on a financial year-to-date basis. However, the enterprise should also disclose any events or transactions that are material to an understanding of the current interim period.

24.6 Periods for which Interim Financial Statements are required to be presented

Interim reports should include interim financial statements (whether condensed or complete) for the periods listed in the following table:

Statement	*Current*	*Comparative*
Balance sheet	End of current interim period	End of immediately preceding financial year
Statement of profit and loss	Current interim period and cumulatively for the year-to-date	Comparable interim period and year-to-date of immediately preceding financial year
Cash flow statement	Cumulatively for the current financial year-to-date	Comparable year-to-date of immediately preceding financial year

24.7 Materiality

In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. For reasons of understandability of the interim figures, materiality for making recognition and disclosure decision is assessed in relation to the interim period financial data. Thus, for example, unusual or extraordinary items, changes in accounting policies or estimates, and prior period items are recognised and disclosed based on materiality in relation to interim period data.

Illustration 1

Sincere Corporation is dealing in seasonal product sales pattern of the product, quarter wise is as follows:

1st quarter 30th June	*10%*
2nd quarter 30th September	*10%*

3rd quarter 31st December	*60%*
4th quarter 31st March	*20%*

Information regarding the 1st quarter ending on 30th June, 2017 is as follows:

Sales	*80 crores*
Salary and other expenses	*60 crores*
Advertisement expenses (routine)	*4 crores*
Administrative and selling expenses	*8 crores*

While preparing interim financial report for first quarter Sincere Corporation wants to defer ₹ 10 crores expenditure to third quarter on the argument that third quarter is having more sales therefore third quarter should be debited by more expenditure. Considering the seasonal nature of business and the expenditures are uniform throughout all quarters, calculate the result of the first quarter as per AS 25. Also give a comment on the company's view.

Solution

Particulars	*(₹ In crores)*	
Result of first quarter ending 30th June, 2017		
Turnover	80	
Other Income	Nil	
Total (a)		80
Less: Changes in inventories		Nil
Salaries and other cost		60
Administrative and selling Expenses (4+8)		12
Total (b)		72
Profit (a)-(b)		8

According to AS 25 the Income and Expense should be recognized when they are earned and incurred respectively. Therefore seasonal incomes will be recognized when they occur. Thus the company's view is not as per AS 25.

Illustration 2

The accounting year of X Ltd. ends on 30th September, 2017 and it makes its reports quarterly. However for the purpose of tax, year ends on 31st March every year. For the Accounting year beginning on 1-10-2016 and ends on 30-9-2017, the quarterly income is as under:-

1st quarter ending on 31-12-2016	*₹ 200 crores*
2nd quarter ending on 31-3-2017	*₹ 200 crores*
3rd quarter ending on 30-6-2017	*₹ 200 crores*
4th quarter ending on 30-9-2017	*₹ 200 crores*
Total	*₹ 800 crores*

Average actual tax rate for the financial year ending on 31-3-2017 is 20% and for financial year ending 31-3-2017 is 30%. Calculate tax expense for each quarter.

Solution

Calculation of tax expense

1st quarter ending on 31-12-2016	200 ×20%	₹ 40 lakhs
2nd quarter ending on 31-3-2016	200 ×20%	₹ 40 lakhs
3rd quarter ending on 30-6-2016	200 ×30%	₹ 60 lakhs
4th quarter ending on 30-9-2016	200 ×30%	₹ 60 lakhs

24.8 Disclosure in Annual Financial Statements

AS 5, requires disclosure, in financial statements, of the nature and (if practicable) the amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods. Similarly, if an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

24.9 Accounting Policies

24.9.1 Same Accounting Policies as annual financial statements

An enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

To illustrate:

a. The principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;

b. A cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet date either to await future information as to whether it has

met the definition of an asset or to smooth earnings over interim periods within a financial year; and

c. Income tax expense is recognised in each interim period based on the best estimate of the weighted average annual effective income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual effective income tax rate changes.

Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. The recognition of items in the balance sheet which do not meet the definition of assets or liabilities is not allowed.

An enterprise that reports more frequently than half-yearly, measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16(d) and 25 require, however, that the nature and amount of any significant changes in estimates be disclosed.

24.9.2 Changes in Accounting Policies

Preparers of interim reports in compliance with AS 25 are required to consider any changes in accounting policies that will be applied for the next annual financial statements, and to implement the changes for interim reporting purposes.

If there has been any change in accounting policy since the most recent annual financial statements, the interim report is required to include a description of the nature and effect of the change.

24.10 Revenue Received Seasonally or Occasionally

Revenues that are received seasonally or occasionally within a financial year should not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the enterprise's financial year.

24.11 Cost Incurred Unevenly During the Financial Year

Costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.

A cost that does not meet the definition of an asset at the end of an interim period is not deferred in the interim balance sheet either to await future information as to whether it has met the definition of an asset, or to smooth earnings over interim periods within a financial year. Thus,

when preparing interim financial statements, the enterprise's usual recognition and measurement practices are followed. The only costs that are capitalized are those incurred after the specific point in time at which the criteria for recognition of the particular class of asset are met. Deferral of costs as assets in an interim balance sheet in the hope that the criteria will be met before the year-end is prohibited.

24.12 Use of Estimates

The measurement procedures to be followed in an interim financial report should be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the enterprise is appropriately disclosed.

24.13 Restatement of Previously Reported Interim Periods

One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. The effect of the principle requires that within the current financial year any change in accounting policy be applied retrospectively to the beginning of the financial year.

24.14 Transitional Provision

On the first occasion that an interim financial report is presented in accordance with this Statement, the following need not be presented in respect of all the interim periods of the current financial year:

a. Comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year; and

b. Comparative cash flow statement for the comparable year-to-date period of the immediately preceding financial year.

24.15 Applicability of AS 25 to Interim Financial Results

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

24.16 Miscellaneous Illustrations

Illustration 3

Accountants of Poornima Ltd. show a net profit of ₹ 7,20,000 for the third quarter of 2016 after incorporating the following:

(i) Bad debts of ₹ 40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.

(ii) Extra ordinary loss of ₹ 35,000 incurred during the quarter has been fully recognized in this quarter.

(iii) Additional depreciation of ₹ 45,000 resulting from the change in the method of charge of depreciation assuming that ₹ 45,000 is the charge for the 3rd quarter only.

Ascertain the correct quarterly income.

Solution

In the above case, the quarterly income has not been correctly stated. As per AS 25 "Interim Financial Reporting", the quarterly income should be adjusted and restated as follows:

Bad debts of ₹ 40,000 have been incurred during current quarter. Out of this, the company has deferred 50% (i.e.) ₹ 20,000 to the next quarter. Therefore, ₹ 20,000 should be deducted from ₹ 7,20,000. The treatment of extra-ordinary loss of ₹ 35,000 being recognized in the same quarter is correct.

Recognising additional depreciation of ₹ 45,000 in the same quarter is in tune with AS 25. Hence, no adjustments are required for these two items.

Poornima Ltd should report quarterly income as ₹ 7,00,000 (₹ 7,20,000 – ₹ 20,000).

Illustration 4

Intelligent Corporation (I–Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:

Quarter I	II	III	IV
Ending 31st March	30th June	30th September	31st December
15%	15%	50%	25%

For the First quarter ending 31st March, 2016, I–Corp. gives you the following information:

	₹ crores
Sales	50
Salary and other expenses	30
Advertisement expenses (routine)	02
Administrative and selling expenses	08

While preparing interim financial report for the first quarter, 'I–Corp.' wants to defer ₹ 21 crores

expenditure to third quarter on the argument that third quarter is having more sales, therefore third quarter should be debited by higher expenditure, considering the seasonal nature of business. The expenditures are uniform throughout all quarters.

Calculate the result of first quarter as per AS 25 and comment on the company's view.

Solution

Result of the first quarter ended 31st March, 2016

		(₹ in crores)
Turnover		50
Add: Other Income		Nil
Total		50
Less: Change in inventories	Nil	
Salaries and other cost	30	
Administrative and selling expenses (8 + 2)	10	40
Profit		10

As per AS 25 on Interim Financial Reporting, the income and expense should be recognised when they are earned and incurred respectively. As per para 38 of AS 25, the costs should be anticipated or deferred only when

(i) it is appropriate to anticipate that type of cost at the end of the financial year, and

(ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of ₹ 21 crores is not tenable as expenditures are uniform throughout all quarters.

Reference: The students are advised to refer the full text of AS 25 "Interim Financial Reporting": (issued 2002).

UNIT 25 : AS 26: INTANGIBLE ASSETS

25.1 Introduction

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

(i) Enterprises whose equity or debt securities are listed on a 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.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. From the date of this Standard becoming mandatory for the concerned enterprises, AS 8; AS 6 & AS 10 stand withdrawn for the aspects relating to Intangible Assets. Infact, AS 8 and AS 6 has been completely withdrawn by the issuing authority and AS 10 has been fully revised in 2016 as standard on 'Property, Plant and Equipment'.

The standard prescribes the accounting treatment for intangible assets that are not dealt with specifically under other accounting standards, and requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. The standard specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

25.2 Scope

This standard should be applied by all enterprises in accounting intangible assets, except

(a) intangible assets that are covered by another AS,

(b) financial assets,

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

(d) intangible assets arising in insurance enterprise from contracts with policy holders,

(e) expenditure in respect of termination benefits.

Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive

industries or by insurance enterprises. This Statement also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

25.3 Definitions

An asset is a resource:

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

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

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

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

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

a. The items traded within the market are homogeneous.

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

c. Prices are available to the public.

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

A financial asset is any asset that is:

a. Cash,

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

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

d. An ownership interest in another enterprise.

25.4 Intangible Assets

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

The key components of the definition are:

- Identifiability; and
- Asset (the definition of which encompasses control).

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks. Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future

economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. If use of physical assets is possible only with the intangible part of it, we treat them as Fixed Assets like Operating system for computers. If physical element is just to support intangible part of it, we treat them as intangible assets.

25.5 Identifiability

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

25.6 Control

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

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality. Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise. As employees may quit the concern anytime or even loyal customers may decide to purchase goods and services from other suppliers. Moreover these items don't even qualify as intangible asset as per the definition given in this AS.

25.7 Future Economic Benefits

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

25.8 Recognition and Initial Measurement of an Intangible Asset

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

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence and

b. The cost of the asset can be measured reliably.

These recognition criteria apply to both costs incurred to acquire an intangible asset and those incurred to generate an asset internally. However, the standard also imposes certain additional criteria for the recognition of internally-generated intangible assets.

When assessing the probability of expected future economic benefits, reasonable and supportable assumptions should be used, representing management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

An intangible asset should be measured initially at cost.

25.9 Separate Acquisition

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

25.10 Acquisition as Part of an Amalgamation

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

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

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

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

25.11 Acquisition by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant.

This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

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

25.12 Internally Generated Intangible Assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into Research Phase & Development Phase. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

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

25.13 Research Phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

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

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

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

25.14 Development Phase

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

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

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

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

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

d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

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

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

Examples of development activities are:

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

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

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

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

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

An enterprise's costing systems can often measure reliably the cost of generating an intangible

asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

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

25.15 Cost of an Internally Generated Intangible Asset

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

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

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

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

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

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

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

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

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

25.16 Items to be Recognised as an Expense

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

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

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

AS 26 states that the following types of expenditure which should always be recognised as an

expense when it is incurred:

- Research;
- Start-up activities (start-up costs), unless the expenditure qualifies to be included in the cost of a tangible fixed asset. Start-up costs include:
- Preliminary expenses incurred in establishment of a legal entity; such as legal and secretarial costs;
- Expenditure to open a new facility or business (ie pre-opening costs); and
- Expenditure prior to starting new operations or launching new products or processes (ie pre-operating costs);
- Training activities;
- Advertising and promotional activities; and
- Relocating or re-organising part or all of an enterprise.

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

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

25.17 Subsequent Expenditure

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

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

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

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

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill. After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

25.18 Amortisation Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

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

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

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

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

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

25.19 Amortisation Method

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

The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

25.20 Residual Value

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

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

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

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

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

25.21 Review of Amortisation Period and Amortisation Method

During the life of an intangible asset, it may become apparent that the estimate of its useful life

is inappropriate. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. Therefore, the amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

25.22 Recoverability of the Carrying Amount-Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28, which will be discussed in the later units of this chapter. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under AS 28 and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition. In addition to the requirements of AS 28, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

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

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

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

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

25.23 Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

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

25.24 Disclosure

The financial statements should disclose the following for each class of intangible assets,

distinguishing between internally generated intangible assets and other intangible assets:

a. The useful lives or the amortisation rates used.

b. The amortisation methods used.

c. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.

d. A reconciliation of the carrying amount at the beginning and end of the period showing:

   i. Additions, indicating separately those from internal development and through amalgamation.

   ii. Retirements and disposals.

   iii. Impairment losses recognised in the statement of profit and loss during the period.

   iv. Impairment losses reversed in the statement of profit and loss during the period.

   v. Amortisation recognised during the period and

   vi. Other changes in the carrying amount during the period.

The financial statements should also disclose:

a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.

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

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

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

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

25.25 Transitional Provisions

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

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

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

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

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

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

25.26 Illustrations

Illustration 1

Dell International Ltd. is developing a new production process. During the financial year 31st March, 2016, the total expenditure incurred on this process was ₹40 lakhs. The production process met the criteria for recognition as an intangible asset on 1st December, 2015. Expenditure incurred till this date was ₹16 lakhs.

Further expenditure incurred on the process for the financial year ending 31st March 2017, was ₹70 lakhs. As at 31-3-2017, the recoverable amount of know-how embodied in the process is estimated to be ₹62 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to work out:

(a) What is the expenditure to be charged to the profit and loss account for the financial year ended 31st March 2016? (Ignore depreciation for this purpose)

(b) What is the carrying amount of the intangible asset as at 31st March 2016?

(c) What is the expenditure to be charged to the profit and loss account for the financial year ended 31st March 2017? (Ignore depreciation for this purpose)

(d) What is the carrying amount of the intangible asset as at 31st March 2017?

Solution

(a) ₹ 16 lakhs

(b) Carrying amount as on 31-3-2016 will be the expenditure incurred after 1-12-2015 = ₹ 24 lakhs

(c) Book cost of intangible asset as on 31-3-2017 is as follows

Total Book cost = ₹ (70 + 24) lakhs = ₹ 94 lakhs

Recoverable amount as estimated = ₹ 62 lakhs

Difference to be charged to Profit and Loss account = ₹ 32 lakhs

(d) ₹ 62 lakhs.

Illustration 2

A Pharma Company spent ₹ 33 lakhs during the accounting year ended 31st March, 2017 on a research project to develop a drug to treat "AIDS". Experts are of the view that it may take four years to establish whether the drug will be effective or not and even if found effective it may take two to three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment.

Solution

As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred. Thus the company cannot treat the expenditure as deferred revenue expenditure. The entire amount of ₹ 33 lakhs spent on research project should be charged as an expense in the year ended 31st March, 2017.

Illustration 3

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

Solution

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

Year	*Net cash flows* ₹	*Amortization Ratio*	*Amortization Amount* ₹
I	-	0.125	10,00,000[1]
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000

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

VII	34,00,000	0.170	10,20,000
Total	2,00,00,000	1.000	80,00,000

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

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

Illustration 4

During 2016-2017, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows:

	Amount (₹)
Completion of detailed programme and design	*25,000*
Coding and Testing	*20,000*
Other coding costs	*42,000*
Testing costs	*12,000*
Product masters for training materials	*13,000*
Duplication of computer software and training materials, from product masters (2,000 units)	*40,000*
Packing the product (1,000 units)	*11,000*

What amount should be capitalized as software costs in the books of the company, on Balance Sheet date?

Solution

As per para 44 of AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed programme design or working model. In this case, ₹ 45,000 would be recorded as an expense (₹ 25,000 for completion of detailed program design and ₹ 20,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (₹ 42,000 + ₹ 12,000 + ₹ 13,000) ₹ 67,000.

Reference: The students are advised to refer the full text of AS 26 "Intangible Assets" (issued 2002).

UNIT 26 : AS 27: FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

26.1 Introduction

AS 27, came into effect in respect of accounting periods commenced on or after 01.04.2002. This standardset out principles and procedures for accounting of interests in joint venture and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors regardless of the structures or forms under which the joint venture activities take place. The standard deals with three broad types of joint ventures – jointly controlled operations, jointly controlled assets and jointly controlled entities. The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, apply only when consolidated financial statements are prepared by venturer. Otherwise, AS 13 will be applicable in venturer's separate financial statements. An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23.

26.2 Scope

This Standard should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.

The provisions of this AS need to be referred to for consolidated financial statement only when CFS is prepared and presented by the venturer.

26.3 Definitions

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

From the above definition we conclude that the essential conditions for any business relation to qualify as joint venture are:

- Two or more parties coming together: Parties can be an individual or any form of business organization say, BOI, AOP, Company, firm.
- Venturers undertake some economic activity: Economic activity means activities with the profit-making motive. Joint venture is separate from the regular identity of the venturers, it may be in the form of independent and separate legal organization other than regular concern of the venturer engaged in the economic activity.

- **Venturers have joint control on the economic activity:** The operating and financial decisions are influenced by the venturers and they also share the results of the economic activity.
- **There exists a contractual agreement:** The relationship between venturers is governed by the contractual agreement. This agreement can be in the form of written and signed agreement or as minutes of venturer meeting or in any other written form.

Joint control is the contractually agreed sharing of control over an economic activity.

Control is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

A **venturer** is a party to a joint venture and has joint control over that joint venture.

An **investor** in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

26.4 Contractual Arrangement

The joint venture covered under this statement is governed on the basis of contractual agreement. Non-existence of contractual agreement will disqualify an organization to be covered in AS 27. Joint ventures with contractual agreement will be excluded from the scope of AS 23 only if the investment qualifies as subsidiary under AS 21, in this case, it will be covered by AS 21. Contractual agreement can be in the form of written contract, minutes of discussion between parties (venturers), articles of the concern or by-laws of the relevant joint venture.

Irrespective of the form of the contract, the content of the contract ideally should include the following points:

- The activity, duration and reporting obligations of the joint venture.
- The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers.
- Capital contributions by the venturers.
- The sharing by the venturers of the output, income, expenses or results of the joint venture.

The main object of contractual agreement is to distribute the economic control among the venturers, it ensures that no venturer should have unilateral control. If contractual agreement is signed by a party to safeguard its right, such agreement will not make the party a venturer. For example, IDBI gave loan to the joint venture entity of L&T and Tantia Construction, they signed an agreement according to which IDBI will be informed for all important decisions of the joint venture entity. This agreement is to protect the right of the IDBI, hence just signing the contractual agreement will not make investor a venturer. Similarly, just because contractual agreement has assigned the role of a manager to any of the venturer will not disqualify him as venturer. For example, Mr. A, M/s. B & Co. and C Ltd. entered into a joint venture, where according to the agreement, all the policies making decisions on financial and operating activities will be taken in a regular meeting attended by them or their representatives.

Implementation and execution of these policies will be the responsibility of Mr. A. Here Mr. A is acting as venturer as well as manager of the concern.

26.5 Forms of Joint Ventures

Joint ventures may take many forms and structures, this Statement identifies them in three broad types - Jointly Controlled Operations (JCO), Jointly Controlled Assets (JCA) and Jointly Controlled Entities (JCE). Any structure which satisfies the following characteristics can be classified as joint ventures: (a) Two or more venturers are bound by a contractual arrangement and (b) The contractual arrangement establishes joint control.

26.6 Jointly Controlled Operations (JCO)

Under this set up, venturers do not create a separate entity for their joint venture business but they use their own resources for the purpose. They raise any funds required for joint venture on their own, they incur any expenses and sales are also realised individually. They use same set of fixed and employees for joint venture business and their own business. Since there is no separate legal entity and venturers don't recognize the transactions separately, they do not maintain a separate set of books for joint venture. All the transactions of joint venture are recorded in their books only. Following are the key features of JCO:

a. Each venturer has his own separate business.

b. There is no separate entity for joint venture business.

c. All venturers are creating their own assets and maintain them.

d. Each venturer record only his own transactions without any separately set of books maintained for the joint venture business.

e. There is a common agreement between all of them.

f. Venturers use their assets for the joint venture business.

g. Venturers met the liabilities created by them for the joint venture business.

h. Venturers met the expenses of the joint venture business from their funds.

i. Any revenue generated or income earned from the joint venture is shared by the venturers as per the contract.

Since the jointly controlled operation is not purchasing assets or raising finance in its own right, the assets and liabilities used in the activities of the joint venture are those of the ventures. As such, they are accounted for in the financial statements of the venture to which they belong. The only accounting issue that arises is that the output from the project is to be shared among the venturers and, therefore, there must be some mechanism for specifying the allocation of the proceeds and the sharing of any joint expenses.

Mr. A (dealer in tiles and marbles), Mr. B (dealer in various building materials) and Mr. C (Promoter) enters into a joint venture business, where any contract for construction received will be completed jointly, say, Mr. A will supply all tiles and marbles, Mr. B will supply other

materials from his godown and Mr. C will look after the completion of construction. As per the contractual agreement, they will share any profit/loss in a predetermined ratio. None of them are using separate staff or other resources for the joint venture business and neither do they maintain a separate account. Everything is recorded in their personal business only. Venturer doesn't maintain a separate set of books but they record only their own transactions of the joint venture business in their books. Any transaction of joint venture recorded separately is only for internal reporting purpose. Once all transactions recorded in venturer financial statement, they don't need to be adjusted for in consolidated financial adjustment.

Illustration 1

Mr. A, Mr. B and Mr. C entered into a joint venture to purchase a land, construct and sell flats. Mr. A purchased a land for ₹ 60,00,000 on 01.01.2016 and for the purpose he took loan from a bank for ₹ 50,00,000 @ 8% interest p.a. He also paid registering fees ₹ 60,000 on the same day. Mr. B supplied the materials for ₹ 4,50,000 from his godown and further he purchased the materials for ₹ 5,00,000 for the joint venture. Mr. C met all other expenses of advertising, labour and other incidental expenses which turnout to be ₹ 9,00,000. On 30.06.2016 each of the venturer agreed to take away one flat each to be valued at ₹ 10,00,000 each flat and rest were sold by them as follow: Mr. A for ₹ 40,00,000; Mr. B for ₹ 20,00,000 and Mr. C for ₹ 10,00,000. Loan was repaid on the same day by Mr. A alongwith the interest and net proceeds were shared by the partners equally.

You are required to prepare the draft Consolidated Profit & Loss Account and Joint Venture Account in the books of each venturer.

Solution

Draft Consolidated Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Purchase of Land:			By Sale of Flats:		
Mr. A		60,00,000	Mr. A	40,00,000	
To Registration Fees:			Mr. B	20,00,000	
Mr. A		60,000	Mr. C	10,00,000	70,00,000
To Materials:			By Flats taken by Venturers:		
Mr. B		9,50,000	Mr. A	10,00,000	
To Other Expenses:			Mr. B	10,00,000	
Mr. C		9,00,000	Mr. C	10,00,000	30,00,000
To Bank Interest:					
Mr. A		2,00,000			
To Profits:					
Mr. A	6,30,000				
Mr. B	6,30,000				
Mr. C	6,30,000	18,90,000			
		1,00,00,000			1,00,00,000

In the Books of Mr. A

Joint Venture Account

Particulars	₹	*Particulars*	₹
To Bank Loan (Purchase of Land)	50,00,000	By Bank (Sale of Flats)	40,00,000
To Bank:(Purchase of Land)	10,00,000	By Land & Building	10,00,000
To Bank (Registration Fees)	60,000	By Bank (Received from Mr. B)	14,20,000
To Bank (Bank Interest)	2,00,000	By Bank (Received from Mr. C)	4,70,000
To Profit on JV	6,30,000		
	68,90,000		68,90,000

In the Books of Mr. B
Joint Venture Account

Particulars	₹	*Particulars*	₹
To Purchases (Material Supplied)	4,50,000	By Bank (Sale of Flats)	20,00,000
To Bank (Materials)	5,00,000	By Land & Building	10,00,000
To Profit on JV	6,30,000		
To Bank (Paid to Mr. A)	14,20,000		
	30,00,000		30,00,000

In the Books of Mr. C
Joint Venture Account

Particulars	₹	*Particulars*	₹
To Bank (Misc. Expenses)	9,00,000	By Bank (Sale of Flats)	10,00,000
To Profit on JV	6,30,000	By Land & Building	10,00,000
To Bank (Paid to Mr. A)	4,70,000		
	20,00,000		20,00,000

26.7 Jointly Controlled Assets (JCA)

Separate legal entity is not created in this form of joint venture but venturer owns the assets jointly, which are used by them for the purpose of generating economic benefit to each of them. They take up any expenses and liabilities related to the joint assets as per the contract. We can conclude the following points:

- There is no separate legal identity.
- There is a common control over the joint assets.
- Venturers use this asset to derive some economic benefit to themselves.
- Each venturer incurs separate expenses for their transactions.

- Expenses on jointly held assets are shared by the venturers as per the contract.
- In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.
- Because the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer, and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.
- Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

For example, ABC Ltd., BP Ltd. and HP Ltd. having the same point of oil refinery and same place of customers agreed to spread a pipeline from their unit to customers place jointly. They agreed to share the expenditure on the pipeline construction and maintenance in the ratio 3:3:4 respectively and the time allotted to use the pipeline was in the ratio 4:3:3 respectively.

For the joint venture, each venturer will record his share of joint assets as *classified according to the nature of the assets rather than as an investment,* and any expenditure incurred or revenue generated will be recorded with other items similar to JCO. Following are the few differences between JCO and JCA for better understanding:

- In JCO venturers uses their own assets for joint venture business but in JCA they jointly owns the assets to be used in joint venture.
- JCO is an agreement to joint carry on the operations to earn income whereas, JCA is an agreement to jointly construct and maintain an asset to generate revenue to each venturer.
- Under JCO all expenses and revenues are shared at an agreed ratio, in JCA only expenses on joint assets are shared at the agreed ratio.

Illustration 2

A Ltd., B Ltd. and C Ltd. decided to jointly construct a pipeline to transport the gas from one place to another that was manufactured by them. For the purpose following expenditure was incurred by them: Buildings ₹ 12,00,000 to be depreciated @ 5% p.a., Pipeline for ₹ 60,00,000 to be depreciated @ 15% p.a., computers and other electronics for ₹ 3,00,000 to be depreciated @ 40% p.a. and various vehicles of ₹ 9,00,000 to be depreciated @ 20% p.a.

They also decided to equally bear the total expenditure incurred on the maintenance of the pipeline that comes to ₹ 6,00,000 each year.

You are required to show the consolidated financial balance sheet and the extract of draft Profit & Loss Account and Balance Sheet for each venturer.

Solution

Consolidated Balance Sheet

		Note	*(₹)*
I	Equity and liabilities		
	Shareholders' funds:		
	Share Capital	1	71,40,000
			71,40,000
II	Assets		
	Non-current Assets		
	Fixed assets:		
	Tangible assets	2	71,40,000
			71,40,000

Notes to Accounts (₹)

1.	Share capital		
	A Ltd.	2,380,000	
	B Ltd.	2,380,000	
	C Ltd.	2,380,000	7,140,000
2.	Tangible assets		
	Land & Building:		
	A Ltd.	380,000	
	B Ltd.	380,000	
	C Ltd.	380,000	1,140,000
	Plant & Machinery:		
	A Ltd.	1,700,000	
	B Ltd.	1,700,000	
	C Ltd.	1,700,000	5,100,000
	Computers:		
	A Ltd.	60,000	
	B Ltd.	60,000	
	C Ltd.	60,000	180,000
	Vehicles:		
	A Ltd.	240,000	
	B Ltd.	240,000	
	C Ltd.	240,000	720,000

In the Books of A Ltd.
Extract of draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	*1*	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	380,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	1,700,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	240,000
			23,80,000

In the Books of B Ltd.
Extract of draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	*1*	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

In the Books of C Ltd.
Extract of Draft Profit & Loss Account

Particulars	₹	₹	*Particulars*	₹	₹
To Depreciation:					
Land & Building	20,000				
Plant & Machinery	300,000				
Computers	40,000				
Vehicles	60,000	420,000			
To Pipeline Expenses		200,000			

Extract of Balance Sheet

	Note No.	₹
Assets		
Non-current assets		
Tangible assets	1	23,80,000

Notes to Accounts

		₹	₹
1.	Land & Building	4,00,000	

	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

26.8 Jointly Controlled Entities (JCE)

This is the format where venturer creates a new entity for their joint venture business. All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity. The net result of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement. This contractual agreement also determines the joint control of the venturer.

Being a separate entity, separate set of books is maintained for the joint venture and in the individual books of venturers the investment in joint venture is recorded as investment (AS 13). Joint venture can be a foreign company operating in India through an Indian concern say Gremo Insurance of Germany contributes 49% of the assets in joint venture in India with Indo Bank Ltd. of India. They agreed to share the net results in 1:1 ratio. The main objective of the joint venture is to exploits the technical expertise of Gremo Insurance and Goodwill of Indo Bank Ltd. It can also be two or more local concerns opening an organization or firm or company contributing their assets to this new joint venture concern and share the profits of the operation in the agreed ratio.

Illustration 3

A Ltd. a UK based company entered into a joint venture with B Ltd. in India, wherein B Ltd. will sell import the goods manufactured by A Ltd. on account of joint venture and sell them in India. A Ltd. and B Ltd. agreed to share the expenses & revenues in the ratio of 5:4 respectively whereas profits are distributed equally. A Ltd. invested 49% of total capital but has equal share in all the assets and is equally liable for all the liabilities of the joint venture. Following is the trail balance of the joint venture at the end of the first year:

Particulars	*Dr. (₹)*	*Cr.(₹)*
Purchases	*9,00,000*	
Other Expenses	*3,06,000*	
Sales		*13,05,000*
Fixed Assets	*6,00,000*	
Current Assets	*2,00,000*	

Unsecured Loans		*2,00,000*
Current Liabilities		*1,00,000*
Capital		*4,01,000*

Closing inventory was valued at ₹ 1,00,000.

You are required to prepare the Consolidated Financial Statement.

Solution

Consolidated Profit & Loss Account

Particulars	*Note No.*	*(₹)*
Revenue from operations	1	13,05,000
Total Revenue (A)		13,05,000
Less: Expenses		
Purchases	2	9,00,000
Other expenses	3	3,06,000
Changes in inventories of finished goods	4	(1,00,000)
Total Expenses (B)		11,06,000
Profit Before Tax (A-B)		1,99,000

Consolidated Balance Sheet

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital	5	4,01,000
	Reserves and Surplus	6	1,99,000
	2. Non-current liabilities		
	Long term borrowings	7	2,00,000
	3. Current Liabilities	8	1,00,000
			9,00,000
II	Assets		
	Non-current Assets		
	Fixed assets	9	6,00,000
	Current Assets		
	Inventories	10	1,00,000
	Other current assets	11	2,00,000
			9,00,000

Notes to Accounts

	Particulars		*(₹)*
1.	Revenue from operations		
	Sales:		
	A Ltd.	7,25,000	
	B Ltd.	5,80,000	13,05,000
2.	Purchases		
	A Ltd.	5,00,000	
	B Ltd.	4,00,000	9,00,000
3.	Other expenses		
	A Ltd.	1,70,000	
	B Ltd.	1,36,000	3,06,000
4.	Closing Inventory		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
5.	Share Capital:		
	A Ltd.	1,96,490	
	B Ltd.	2,04,510	4,01,000
6.	Reserves and Surplus		
	Profit & Loss Account:		
	A Ltd.	99,500	
	B Ltd.	99,500	1,99,000
7.	Long Term Borrowings		
	Unsecured Loans:		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000
8.	Current Liabilities:		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
9.	Fixed Assets:		
	A Ltd.	3,00,000	
	B Ltd.	3,00,000	6,00,000
10.	Inventories		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000

11.	Other Current Assets:		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000

26.9 Consolidated Financial Statements of a Venturer

Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Proportionate consolidation method of accounting is to be followed except in the following cases:

a. Investment is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

b. The term 'Near Future' is explained with AS 21.

   Or joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

   In both the above cases, investment of venturer in the share of the investee is treated as investment according to AS 13.

A venturer should discontinue the use of the proportionate consolidation method from the date that:

a. It ceases to have joint control in the joint venture but retains, either in whole or in part, its investment.

b. The use of the proportionate consolidation method is no longer appropriate because the joint venture operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturers.

From the date of discontinuing the use of the proportionate consolidation method,

a. If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statement.

b. If interest is 20% or more but upto 50%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statement.

c. For all other cases investment in joint venture is treated as per AS 13, Accounting for Investment.

d. For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

Following are the features of Proportionate Consolidation Method:

a. Stress is given on substance over form i.e., more importance is given to the share of venturers in the profit or loss of the venture from the share of assets and liabilities rather than the nature and form of the joint venture.

b. Venturer's share of joint assets, liabilities, expenses and income are shown on the separate lines in the consolidated financial statement.

For example, Mr. A enters into a joint venture with Mr. B and has contributed 33% of the total fixed assets and has share of 40% in current assets and current liabilities. Its share in net result is 50%. Consolidated Balance Sheet will be prepared by Mr. A as follow:

Consolidated Balance Sheet

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital	1	1,00,000
	2. Current Liabilities	2	50,000
			1,50,000
II	Assets		
	Non-current Assets		
	Fixed assets	3	75,000
	Current Assets	4	75,000
			1,50,000

Notes to Accounts

1.	Share Capital:		
	A	33,000	
	B	67,000	1,00,000
2.	Current Liabilities:		
	A	20,000	
	B	30,000	50,000
3.	Fixed Assets:		
	A	25,000	
	B	50,000	75,000
4.	Current Assets:		
	A	30,000	
	B	45,000	75,000

Similar to above all the items of expenses and income will also be classified line by line for each item. The whole basis of this provision is to bring transparency in the books of account. If there is any special clause for sharing of expenses, income or any other item that should be clearly disclosed in the consolidated financial statement.

c. Most of the provisions of Proportionate Consolidation Method are similar to the provisions of AS 21.

d. As far as possible the reporting date of the financial statements of jointly controlled entity and venturers should be same. If practically it is not possible to draw up the financial statements to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made in joint venturer's books for the effects of significant transactions or other events that occur between the jointly controlled entity's date and the date of the venturer's financial statements. In any case, the difference between reporting dates should not be more than six months.

e. Accounting policies followed in the preparation of the financial statements of the jointly controlled entity and venturer should be uniform for like transactions and other events in similar circumstances.

   If accounting policies followed by venturer and jointly controlled entity are not uniform, then adjustments should be made in the items of the venturer to bring it in line with the accounting policy of the joint venture.

f. Any asset or liability should not be adjusted by another liability or asset. Similarly any income or expense cannot be adjusted with another expense or income. Such adjustment can be made only when legally it is allowed to adjust them and such items does lead to settlement of obligation or writing off of assets.

g. On the date when interest in joint entity is acquired, if the interest of venturer in net assets of the entity is less than the cost of investment in joint entity, the difference will be recognized as goodwill in the consolidated financial statement and if net asset is more than cost of investment, then the difference is recognized as capital reserve.

   In case the carrying amount of investment is different than cost of investment, we take carrying amount for the purpose of the above calculation.

h. An investor who don't have joint control in the entity is like associate as discussed in AS 23, therefore the treatment of losses will be similar to AS 23. If investor's share in loss of the joint entity is in excess of his interest in net asset, this excess loss will be recognized by the venturers. In future when entity starts reporting profits, investor's share of profits will be provided to venturer till total amount is equivalent to absorbed losses.

Illustration 4

A Ltd. entered into a joint venture with B Ltd. on 1:1 basis and a new company C Ltd. was formed for the same purpose and following is the balance sheet of all the three companies:

Particulars	*A Ltd.*	*B Ltd.*	*C Ltd.*
Share Capital	*1,000,000*	*750,000*	*500,000*
Reserve & Surplus	*1,800,000*	*1,600,000*	*1,200,000*
Loans	*300,000*	*400,000*	*200,000*
Current Liabilities	*400,000*	*250,000*	*100,000*
Fixed Assets	*3,050,000*	*2,625,000*	*1,950,000*

Investment in JV	*250,000*	*250,000*	*-*
Current Assets	*200,000*	*125,000*	*50,000*

Prepare the balance sheet of A Ltd. and B Ltd. under proportionate consolidation method.

Solution

Balance Sheet of A Ltd.

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital		10,00,000
	Reserves and Surplus	1	24,00,000
	2. Non-current liabilities	2	4,00,000
	3. Current Liabilities	3	4,50,000
	TOTAL		42,50,000
II	Assets		
	Non-current Assets		
	Fixed assets:	4	40,25,000
	Current Assets	5	2,25,000
			42,50,000

Notes to Accounts

1.	Reserves and Surplus		
	A Ltd.	18,00,000	
	C Ltd.	6,00,000	24,00,000
2.	Long Term Borrowings		
	Loans:		
	A Ltd.	3,00,000	
	C Ltd.	1,00,000	4,00,000
3.	Current Liabilities:		
	A Ltd.	4,00,000	
	C Ltd.	50,000	4,50,000
4.	Fixed Assets:		
	A Ltd.	30,50,000	
	C Ltd.	9,75,000	40,25,000

5.	Current Assets:		
	A Ltd.	2,00,000	
	C Ltd.	25,000	2,25,000

Balance Sheet of B Ltd.

		Note No.	*(₹)*
I	Equity and liabilities		
	1. Shareholders' funds:		
	Share Capital		7,50,000
	Reserves and Surplus	1	22,00,000
	2. Non-current liabilities	2	5,00,000
	3. Current Liabilities	3	3,00,000
			37,50,000
II	Assets		
	1. Non-current Assets		
	Fixed assets	4	36,00,000
	2. Current Assets	5	1,50,000
			37,50,000

Notes to Accounts

1.	Reserves and Surplus		
	A Ltd.	16,00,000	
	C Ltd.	6,00,000	22,00,000
2.	Long Term Borrowings		
	Loans:		
	A Ltd.	4,00,000	
	C Ltd.	1,00,000	5,00,000
3.	Current Liabilities:		
	A Ltd.	2,50,000	
	C Ltd.	50,000	3,00,000
4.	Fixed Assets:		
	A Ltd.	26,25,000	
	C Ltd.	9,75,000	36,00,000
5.	Current Assets:		
	A Ltd.	1,25,000	
	C Ltd.	25,000	1,50,000

26.10 Transactions between a Venturer and Joint Venture

When venturer transfers or sells assets to Joint Venture, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss only when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

When the venturer from the joint venture purchases the assets, venturer will not recognized his share of profits in the joint venture of such transaction unless he disposes off the assets. A venturer should recognise his share of the losses resulting from these transactions in the same way as profits except that losses will be recognised in full immediately only when they represent a reduction in the net realisable value of current assets or an impairment loss.

In case the joint venture is in the form of separate entity then provisions of above the Para will be followed only for consolidated financial statement and not for venturer's own financial statement. In the books of venturer, profit or loss from such transactions are recognised in full.

26.11 Reporting Interests in Joint Ventures in the Financial Statements of an Investor

The investors who don't have joint control over the entity recognized his share of net results and his investments in joint venture as per AS 13. In the consolidated financial statement it is recognized as per AS 13, AS 21 or AS 23 as appropriate.

26.12 Operators of Joint Ventures

Payment to operators is recognized as expense in CFS and in the books of the operators as per AS 9, Revenue Recognition. The operator may any of the venturer, in this case any amount received by him, as management fees for the service will be recognized as stated above in this Para.

26.13 Disclosures

A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

a. Any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

b. Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

c. Those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

a. Any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

b. Its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

Reference: The students are advised to refer the full text of AS 27 "Financial Reporting of Interests in Joint Ventures" (issued 2002).

UNIT 27: AS 28: IMPAIRMENT OF ASSETS

27.1 Introduction

AS 28 came into effect in respect of accounting period commenced on or after 1-4-2004 and is mandatory in nature from that date for 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.

In respect of all other enterprises, the Accounting Standard came into effect in respect of accounting periods commenced on or after 1-4-2005 and is mandatory in nature from that date.

This standard prescribes the procedures to be applied to ensure that the assets of an enterprise are carried at an amount not exceeding their recoverable amount (amount to be recovered through use or sale of the asset). The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets. An enterprise is required to assess at each balance sheet date whether there is an indication that an enterprise may be impaired. If such an indication exists, the enterprise is required to estimate the recoverable amount and the impairment loss, if any, should be recognised in the profit and loss account.

27.2 Scope

The standard should be applied in accounting for impairment of all assets except

1. inventories (AS 2),
2. assets arising under construction contracts (AS 7),
3. financial assets including investments covered under AS 13, and deferred tax assets (AS 22).

There are chances that the provision on account of impairment losses may increase sickness of companies and potentially sick companies may actually become sick.

Therefore, AS 28 applies to (among other assets):

- Land and buildings;
- Plant and machinery;
- Investment property;
- Intangible assets;
- Goodwill;
- Assets carried at revalued amounts under AS 10.

27.3 Assessment

An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset. An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

External sources of information

a. During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

b. Significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated.

c. Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

d. The carrying amount of the net assets of the reporting enterprise is more than its market capitalization.

Internal sources of information

a. Evidence is available of obsolescence or physical damage of an asset.

b. Significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date and

c. Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated.

If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard 6, even if no impairment loss is recognised for the asset.

27.4 Measurement of Recoverable Amount

Recoverable amount for an asset is defined by the statement as the higher of net selling price or value of use. If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for an asset that is held for disposal. Otherwise, if it is not possible to determine the selling price we take value in use of assets as it's recoverable amount.

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs, unless either:

a. The asset's net selling price is higher than its carrying amount; or

b. The asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

The best evidence for net selling price is a price in the bidding sales agreement for the disposal of the assets or similar assets. In the absence of this net selling price is estimated from the transactions for the assets in active market, if the asset has the active market. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

Value in Use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Estimating the value in use of an asset involves the following steps:

a. Estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and

b. Applying the appropriate discount rate to these future cash flows.

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

Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

Depreciation (Amortisation) is a systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Useful life is either:

- The period of time over which an asset is expected to be used by the enterprise; or
- The number of production or similar units expected to be obtained from the asset by the enterprise.

27.5 Basis for Estimates of Future Cash Flows

Cash flow projections should be based on the most recent budgets/forecasts for a maximum of five years. Financial budgets/forecasts over a period longer than five years may be used if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

Cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence.

27.6 Composition of Estimates of Future Cash Flows

Estimates of future cash flows should include (i) Projections of net cash inflows from the continuing use of the asset and (ii) Net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Care should be taken for the following points:

a. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale should be included.

b. Cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review should not be included.

c. Cash outflows that relate to obligations that have already been recognised as liabilities to be excluded.

d. Future cash outflows or inflows expected to arise because of restructuring of the organization should be not considered.

e. Any future capital expenditure enhancing the capacity of the assets should be excluded.

f. Any increase in expected cash inflow from the above expenditure should also be excluded.

g. Estimates of future cash flows should not include cash inflows or outflows from financing activities and also income tax receipts or payments.

Foreign Currency Future Cash Flows are estimated in the currency it will be generated and after they are discounted for the time value of money, we convert them in the reporting currency on the basis of AS 11.

Discount Rate

The discount rate(s) should be a pre-tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset.

27.7 Recognition and Measurement of an Impairment Loss

If recoverable amount of assets more than carrying amount, we ignore the difference and asset is carried on at the same book value. But when this recoverable amount is less than the carrying amount, this difference termed as Impairment Loss should be written off immediately as expenses to Profit & Loss Account. If assets are carried out at revalued figures then the impairment loss equivalent to revalued surplus is adjusted with it and the balance (if any) is charged to Profit & Loss Account. Depreciation for the coming years on the assets are recalculated on the basis of the new carrying amount, residual value and remaining useful life of the asset, according to AS 10.

27.8 Identification of the Cash-Generating Unit to which an Asset Belongs

A *cash generating unit* is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset, if it is not possible to estimate the recoverable amount of the individual asset because the value in use of the asset cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the asset belongs.

If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise, this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash-generating

unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output. Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

27.9 Recoverable Amount and Carrying Amount of a Cash-Generating Unit

The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined i.e. carrying amount is the summation of the carrying amount of all the assets grouped under one cash-generating unit. This also includes the liability only if that liability is necessary to be considered to determine the recovery amount. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount. For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit or liabilities that have already been recognised in the financial statements. In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

27.10 Goodwill

Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs. This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognized. If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test

27.11 Corporate Assets

Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review. For each identified corporate asset:

a. If the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and

b. If the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom-up' and 'top-down' tests.

27.12 Impairment Loss for a Cash-Generating Unit

The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

a. First, to goodwill allocated to the cash-generating unit (if any); and

b. Then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets

The carrying amount of an asset should not be reduced below the highest of:

a. Its net selling price (if determinable);

b. Its value in use (if determinable); and

c. Zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

27.13 Reversal of an Impairment Loss

An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss. Indications of a potential decrease in an impairment loss are mainly mirror the indications of a potential impairment loss discussed above as external and internal indicators. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

27.14 Reversal of an Impairment Loss for an Individual Asset

If impairment loss was written off to profit and loss account, then the reversal of impairment

loss should be recognized as income in the financial statement immediately. If impairment loss was adjusted with the Revaluation Reserve; then reversal of impairment loss will be written back to the reserve account to the extent it was adjusted, any surplus will be recognised as revenue. But in any case the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods. This is mainly because any further increase in value of asset is revaluation, which is governed by AS 10.

After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

27.15 Reversal of an Impairment Loss for a Cash-Generating Unit

A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

a. First, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and

b. Then, to goodwill allocated to the cash-generating unit (if any),

27.16 Reversal of an Impairment Loss for Goodwill

This Statement does not permit an impairment loss to be reversed for goodwill because of a change in estimates, an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

a. The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and

b. Subsequent external events have occurred that reverse the effect of that event.

27.17 Impairment in case of Discontinuing Operations

In applying this Statement to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit. For example:

a. If the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation. Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Statement;

b. If the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and

c. If the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

27.18 Disclosure

For each class of assets, the financial statements should disclose:

a. The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

b. The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

c. The amount of impairment losses recognised directly against revaluation surplus during the period; and

d. The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

a. The amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and

b. The amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

a. The events and circumstances that led to the recognition or reversal of the impairment loss;

b. The amount of the impairment loss recognised or reversed;

c. For an individual asset:

   (i) The nature of the asset; and

   (ii) The reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);

d. For a cash-generating unit:

   (i) A description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);

(ii) The amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and

(iii) If the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;

e. Whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

f. If recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

g. If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

a. The main classes of assets affected by impairment losses (reversals of impairment losses);

b. The main events and circumstances that led to the recognition (reversal) of these impairment losses.

27.19 Transitional Provisions

On the date of this Statement becoming mandatory, an enterprise should assess whether there is any indication that an asset may be impaired (see paragraphs 5-13). If any such indication exists, the enterprise should determine impairment loss, if any, in accordance with this Statement. The impairment loss, so determined, should be adjusted against opening balance of revenue reserves being the accumulated impairment loss relating to periods prior to this Statement becoming mandatory unless the impairment loss is on a revalued asset. An impairment loss on a revalued asset should be recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset. If the impairment loss exceeds the amount held in the revaluation surplus for that same asset, the excess should be adjusted against opening balance of revenue reserves. Any impairment loss arising after the date of this Statement becoming mandatory should be recognised in accordance with this Statement (i.e., in the statement of profit and loss unless an asset is carried at revalued amount. An impairment loss on a revalued asset should be treated as a revaluation decrease).

27.20 Illustrations

Illustration 1

Ergo Industries Ltd. gives the following estimates of cash flows relating to fixed asset on 31-12-2016. The discount rate is 15%.

Year	*Cash Flow (₹ in lakhs)*
2017	*4000*
2018	*6000*
2019	*6000*
2020	*8000*
2021	*4000*

Residual value at the end of 2021	=	*₹ 1000 lakhs*
Fixed Asset purchased on 1-1-2017	=	*₹ 40,000 lakhs*
Useful life	=	*8 years*
Net selling price on 31-12-2016	=	*₹ 20,000 lakhs*

Calculate on 31-12-2016:

(a) Carrying amount at the end of 2016

(b) Value in use on 31-12-2016

(c) Recoverable amount on 31-12-2016

(d) Impairment loss to be recognized for the year ended 31-12-2016

(e) Revised carrying amount

(f) Depreciation charge for 2017

Solution

Calculation of value in use

Year	*Cash Flow*	*Discount as per 15%*	*Discounted cash flow*
2017	4,000	0.870	3,480
2018	6,000	0.756	4,536
2019	6,000	0.658	3,948
2020	8,000	0.572	4,576
2021	4,000	0.497	1,988
2021	(residual) 1,000	0.497	497
			19,025

(a) Calculation of carrying amount:

Original cost = ₹ 40,000 lakhs

Depreciation for 3 years = [(40,000-1000)×3/8] = ₹ 14,625 lakhs

Carrying amount on 31-12-2016 = [40,000-14,625] = ₹ 25,375 lakhs

(b) Value in use = ₹ 19,025 lakhs

Net Selling Price = ₹ 20,000 lakhs

Recoverable amount = higher of value in use and net selling price i.e. ₹ 20,000 lakhs.

(c) Recoverable amount = ₹ 20,000 lakhs

(d) Impairment Loss = ₹ (25,375-20,000) = ₹ 5,375 lakhs

(e) Revised carrying amount = ₹ (25,375-5,375) = ₹ 20,000 lakhs

(f) Depreciation charge for 2017 = (20,000-1000)/5 = ₹ 3,800 lakhs

Illustration 2

X Ltd. is having a plant (asset) carrying amount of which is ₹ 100 lakhs on 31.3.2017. Its balance useful life is 5 years and residual value at the end of 5 years is ₹ 5 lakhs. Estimated future cash flow from using the plant in next 5 years are:

For the year ended on	*Estimated cash flow (₹ in lakhs)*
31.3.2018	50
31.3.2019	30
31.3.2020	30
31.3.2021	20
31.3.2022	20

Calculate "value in use" for plant if the discount rate is 10% and also calculate the recoverable amount if net selling price of plant on 31.3.2017 is ₹ 60 lakhs.

Solution

Present value of future cash flow

Year ended	*Future Cash Flow*	*Discount @ 10% Rate*	*Discounted cash flow*
31.3.2018	50	0.909	45.45
31.3.2019	30	0.826	24.78
31.3.2020	30	0.751	22.53
31.3.2021	20	0.683	13.66
31.3.2022	20	0.620	12.40
			118.82
Present value of residual price on 31.3.2022 = 5 × 0.620			3.10
Present value of estimated cash flow by use of an asset and residual value, which is called "value in use".			121.92

If net selling price of plant on 31.3.2017 is ₹ 60 lakhs, the recoverable amount will be higher of ₹ 121.92 lakhs (value in use) and ₹ 60 lakhs (net selling price), hence recoverable amount is ₹ 121.92 lakhs.

Reference: The students are advised to refer the full text of AS 28 "Impairment of Assets" (issued 2002).

UNIT 28 : AS 29 : PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

28.1 Introduction

AS 29 came into effect in respect of accounting periods commenced on or after 1-4-2004. The objective of AS 29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. This standard applies in accounting for provisions and contingent liabilities and contingent assets resulting from financial instruments (not carried at fair value) and insurance enterprises (other than those arising from contracts with policyholders).

The standard will not apply to provisions/liabilities resulting from executor contracts and those covered under any other accounting standard.

This Standard is mandatory in nature from that date:

a. In its entirety, for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

   i. Enterprises whose equity or debt securities are listed whether in India or outside India.

   ii. Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

   iii. Banks including co-operative banks.

   iv. Financial institutions.

   v. Enterprises carrying on insurance business.

   vi. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 50 crore. Turnover does not include 'other income'.

   vii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 10 crore at any time during the accounting period.

   viii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

b. In its entirety, except paragraph 67, for the enterprises which do not fall in any of the categories in (a) above but fall in any one or more of the following categories:

   i. All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds ₹ 40 lakhs but does not exceed ₹ 50 crore. Turnover does not include 'other income'.

ii. All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of ₹ 1 crore but not in excess of ₹ 10 crore at any time during the accounting period.

iii. Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

c. In its entirety, except paragraphs 66 and 67, for the enterprises, which do not fall in any of the categories in (a) and (b) above.

Where an enterprise has been covered in any one or more of the categories in (a) above and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from paragraph 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) above for two consecutive years.

Where an enterprise has been covered in any one or more of the categories in (a) or (b) above and subsequently, ceases to be covered in any of the categories in (a) and (b) above, the enterprise will not qualify for exemption from paragraphs 66 and 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) and (b) above for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, but no longer qualifies for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, in the current accounting period, this Standard becomes applicable, in its entirety or, in its entirety except paragraph 67, as the case may be, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraph 67 or paragraphs 66 and 67, as the case may be, should disclose the fact.

28.2 Scope

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

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

b. Those resulting from executory contracts;

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

d. Those covered by another Accounting Standard.

Where another Accounting Standard like 7; 9; 15; 19; 22 & 24 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of this Standard.

28.3 Definitions

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

Examples of executory contracts include:

- Employee contracts in respect of continuing employment;
- Contracts for future delivery of services such as gas and electricity;
- Obligations to pay local authority charges and similar levies; and
- Most purchase orders.

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

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

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

A Contingent liability is:

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

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

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

  (ii) A reliable estimate of the amount of the obligation cannot be made.

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

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

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

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

(a) The scope of a business undertaken by an enterprise; or

(b) The manner in which that business is conducted.

28.4 Provisions

A provision should be recognised when:

(a) An enterprise has a present obligation as a result of a past event;

(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) A reliable estimate can be made of the amount of the obligation.

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

28.5 Present Obligation

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

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

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

28.6 Past Event

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

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

28.7 Probable Outflow of Resources Embodying Economic Benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

For the purpose of this Statement, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

28.8 Reliable Estimate of the Obligation

The use of estimates is an inherent part of preparing financial statements. Provisions require a greater degree of estimation than most other items, but AS 29 emphasises that it should not be impossible to determine a range of possible outcomes and, from this range, to reach an appropriate conclusion that is sufficiently reliable for the provision to be recognised. AS 29 concludes that the circumstances in which it will not be possible to reach a reliable estimate, will be extremely rare.

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

28.9 Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

28.10 Contingent Assets

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

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority.

28.11 Measurement -Best Estimate

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The amount of a provision should not be

discounted to its present value *except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment. The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.* The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

28.12 Future Events

It is only those obligations arising from past events that exist independently of the enterprise's future actions (ie the future conduct of its business) that are recognised as provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

28.13 Expected Disposal of Assets

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

28.14 Reimbursements

An, enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via:

- An insurance contract arranged to cover a risk;
- An indemnity clause in a contract; or
- A warranty provided by a supplier.

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Consequently, such a reimbursement should be recognised only when it is virtually certain that it will be received consequent upon the settlement of the obligation.

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

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

28.15 Changes in Provisions

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

28.16 Use of Provisions

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

28.17 Application of the Recognition and Measurement Rules

28.17.1 Future Operating Losses

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

28.17.2 Restructuring

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

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

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

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

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

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

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

(a) Necessarily entailed by the restructuring; and

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

A restructuring provision does not include such costs as:

(a) Retraining or relocating continuing staff;

(b) Marketing; or

(c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

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

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

28.18 Disclosure

For each class of provision, an enterprise should disclose:

(a) The carrying amount at the beginning and end of the period;

(b) Additional provisions made in the period, including increases to existing provisions;

(c) Amounts used (i.e. incurred and charged against the provision) during the period; and

(d) Unused amounts reversed during the period.

SMCs are exempt from the disclosure requirements of AS 29

An enterprise should disclose the following for each class of provision:

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

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

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

SMCs are exempt from the disclosure requirements of AS 29

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

(a) An estimate of its financial effect,

(b) An indication of the uncertainties relating to any outflow; and

(c) The possibility of any reimbursement.

28.19 Transitional Provisions

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

28.20 Miscellaneous Illustrations

Illustration 1

At the end of the financial year ending on 31st December, 2017, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	*Loss (₹)*
In respect of five cases (Win)	*100%*	*–*
Next ten cases (Win)	*60%*	*–*
Lose (Low damages)	*30%*	*1,20,000*
Lose (High damages)	*10%*	*2,00,000*
Remaining five cases		
Win	*50%*	*–*
Lose (Low damages)	*30%*	*1,00,000*
Lose (High damages)	*20%*	*2,10,000*

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

Solution

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

(i) There is a present obligation arising out of past events but not recognized as provision.

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

(iii) The possibility of an outflow of resources embodying economic benefits is also remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining

five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is remote, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

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

= ₹ 36,000 + ₹ 20,000

= ₹ 56,000

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

= ₹ 30,000 + ₹ 42,000

= ₹ 72,000

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

Reference: The students are advised to refer the full text of AS 29 "Provisions, Contingent Liabilities and Contingent Assets" (issued 2003).

UNIT 29 : GUIDANCE NOTES

29.1 Introduction

Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. In recent years several Guidance Notes on accounting aspects have been issued promptly responding to the need for accounting guidance on contemporary issues, which arise due to amendments in laws and other developments related to economic reforms in the country. These Guidance Notes are issued by the Council of the ICAI from time to time.

Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

29.2 Status of Guidance Notes

In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

Similarly, in a situation where certain matters are covered by a recommendatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the recommendatory Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard coming into effect, unless otherwise specified in the new Accounting Standard.

In a situation where certain matters are covered by a mandatory Accounting Standard and subsequently, an Accounting Standard is issued which also covers those matters, the earlier Accounting Standard or the relevant portion thereof will be considered as superseded from the date of the new Accounting Standard becoming mandatory, unless otherwise specified in the new Accounting Standard.

29.3 Guidance Notes on Accounting Aspects

The following is the list of applicable guidance notes on accounting aspects:

1. GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements.
2. GN(A) 6 (Issued 1988) Guidance Note on Accrual Basis of Accounting.

3. GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax.
4. GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty.
5. Guidance Note on Accounting Treatment for MODVAT/ CENVAT.
6. GN(A) 18 (Issued 2005) Guidance Note on Accounting for Employee Share-base Payments.
7. GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961.
8. GN(A) 24 (Issued 2006) Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25.
9. Guidance Note on Applicability of AS 25 to Interim Financial Results.
10. Guidance Note on Turnover in case of Contractors.
11. Guidance Note on Schedule III to the Companies Act, 2013.
12. *Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities.*
13. *Guidance Note on Accounting for Derivative Contracts.*
14. *Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013.*

The students are advised to go through the full text of all the Guidance Notes from the Accounting Pronouncements given along with this Study Material. Students may also check the following link for the full text of the Guidance Notes on our Institute's website:

http://www.icai.org/post.html?post_id=1399

29.4 An Overview of Guidance Notes

GN(A) 5 (Issued 1983) Guidance Note on Terms Used in Financial Statements

The objective of this guidance note is to facilitate a broad and basic understanding of the various terms as well as to promote consistency and uniformity in their usage. The terms have been defined in this guidance note, keeping in view their usage in the preparation and presentation of the financial statements. Some of these terms may have different meanings when used in the context of certain special enactments. The definitions of the terms in this guidance note do not spell out the accounting procedure and are not prescriptive of a course of action.

GN(A) 6 (Issued 1988) Guidance Note on Accrual Basis of Accounting

This guidance note is issued by the Research Committee of the ICAI providing guidance in respect of maintenance of accounts on the accrual basis of accounting. The Guidance Note explains the concept of accrual as a basis of accounting, particularly, in comparison with the cash basis of accounting. It also deals generally with the matters of recognition of revenue and

expenses, assets and liabilities. A section of the Guidance Note is devoted to the concept of materiality *vis-a-vis* accrual basis of accounting. It also provides guidance to the auditor in case a company has not maintained its accounts on accrual basis. Illustrations highlighting application of the principles explained in the Guidance Note to certain important commercial situations have also been given in the Guidance Note.

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. "Accrual" is one of the fundamental accounting assumptions. Para 27 of the Accounting Standard on Disclosure of Accounting Policies (AS 1), issued by the Institute of Chartered Accountants of India (ICAI), provides that if fundamental accounting assumptions, viz., going concern, consistency and accrual are not followed, the fact should be disclosed.

GN(A) 11 (Issued 1997) Guidance Note on Accounting for Corporate Dividend Tax

Corporate Dividend Tax (CDT) is in addition to the income-tax chargeable in respect of the total income of a domestic company and was introduced under The Finance Act, 1997. The Guidance Note on Accounting for Corporate Dividend Tax explains the salient features of Corporate Dividend tax (CDT). As per the Guidance Note, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year. The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed 'below the line', it is appropriate that the liability in respect of CDT should also be disclosed 'below the line' as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

GN(A) 12 (Revised 2000) Guidance Note on Accounting Treatment for Excise Duty

Excise duty is a duty on manufacture or production of excisable goods in India. Section 3 of the Central Excise Act, 1944, deals with charge of Excise Duty. This Section provides that a duty of excise on excisable goods which are produced or manufactured in India shall be levied and collected in such manner as may be prescribed. The subject of accounting of excise duty has, so far, beset with certain controversies, yet, the ICAI with the issuance of this Guidance Note, has recommended practices which are broadly in accordance with the generally accepted accounting principles would be well established. Subsequent to the issuance of that Guidance Note, the nature of excise duty has been further clarified by some Supreme Court decisions. Further, the principles to be followed for the valuation of inventories have been explained in the Accounting Standard (AS) 2 on 'Valuation of Inventories' issued by the Institute of Chartered Accountants of India. This Guidance Note recommends accounting treatment for Excise Duty in respect of excisable goods produced or manufactured by an enterprise. A separate Guidance Note on Accounting Treatment for MODVAT sets out principles for accounting for MODVAT (now renamed as 'CENVAT'). In considering the appropriate treatment of excise duty for the purpose of determination of cost for inventory valuation, it is necessary to consider whether excise duty should be considered differently from other expenses. As per the recommendations given in the Guidance Note, Excise duty

should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation. Where excise duty is paid on excisable goods and such goods are subsequently utilised in the manufacturing process, the duty paid on such goods, if the same is not recoverable from taxing authorities, becomes a manufacturing cost and must be included in the valuation of work-in-progress or finished goods arising from the subsequent processing of such goods. Where the liability for excise duty has been incurred but its collection is deferred, provision for the unpaid liability should be made. Excise duty cannot be treated as a period cost and if the method of accounting for excise duty is not in accordance with the principles explained in this Guidance Note, the auditor should qualify his report.

GN(A) 25 Guidance Note on Accounting Treatment for MODVAT/CENVAT

The objective of this Guidance Note is to provide guidance in respect of accounting for MODVAT/CENVAT credit. Salient features of MODVAT and CENVAT are also explained in the guidance note. For accounting treatment of excise duty with regard to valuation of inventories, reference may be made to the Guidance Note on Accounting Treatment for Excise Duty, issued by the Institute of Chartered Accountants of India.

GN(A) 18 (Issued 2005) Guidance Note on Accounting for Employee Share-based Payments

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

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

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

An employee share-based payment plan falling in the above categories can be accounted for by adopting the fair value method or the intrinsic value method. The accounting treatment recommended here in below is based on the fair value method.

An enterprise should recognise as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in this Guidance Note. If the shares or stock options granted vest immediately, the employee is not required to

complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognise services received in full with a corresponding credit to the equity account. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 9 to 11). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognised for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognised for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, the enterprise should recognise an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised,

the balance standing to the credit of the relevant equity account should be transferred to general reserve.

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognised in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, mutatis mutandis, in place of the fair value as described in paragraphs 5 to 14.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements. The appendices to the Guidance Note provide detailed guidance on measurement of fair value of shares and stock options, including determination of various inputs to the option-pricing models and examples to illustrate application of various principles recommended in the Guidance Note.

GN(A) 22 (Issued 2006) Guidance Note on Accounting for Credit Available in Respect of Minimum Alternative Tax under the Income-tax Act, 1961

The Finance Act, 2005, inserted sub-section (1A) to section 115JAA, to grant tax credit in respect of MAT paid under section 115JB of the Act with effect from assessment year 2006-07. This Guidance Note deals with various aspects of accounting and presentation of MAT paid and the credit available in this regard. The Guidance Note describes the salient features of MAT credit and its accounting treatment. MAT credit should be recognised as an asset only when and to the extent there is convincing evidence that the company will pay normal income tax during the specified period. MAT credit is a deferred tax asset for the purposes of AS 22. A company should write down the carrying amount of the MAT credit asset to the extent there is no longer a convincing evidence to the effect that the company will pay normal income tax

during the specified period. Where a company recognises MAT credit as an asset on the basis of the considerations specified in the guidance note, the same should be presented under the head 'Loans and Advances' since, there being a convincing evidence of realisation of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'. In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph the guidance note. According to paragraph 6 of Accounting Standards Interpretation (ASI) 6*, 'Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961', issued by the Institute of Chartered Accountants of India, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the profit and loss account in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognised as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the profit and loss account and presented as a separate line item therein.

GN(A) 24 (Issued 2006) Guidance Note on Measurement of Income Tax Expense for Interim Financial Reporting in the Context of AS 25

Accounting Standard (AS) 25, 'Interim Financial Reporting', issued by the Council of the Institute of Chartered Accountants of India (ICAI), prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period. AS 25 became mandatory in respect of accounting periods commencing on or after 1st April, 2002. In accordance with the Accounting Standards Interpretation (ASI) 27, 'Applicability of AS 25 to Interim Financial Results', the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in the interim financial results presented under Clause 41 of the Listing Agreement entered into between stock exchanges and the listed enterprises. This Guidance Note deals with the measurement of income tax expense for the purpose of inclusion in the interim financial reports. Accounting for interim period income-tax expense is based on the approach prescribed in AS 25 that the interim period is part of the whole accounting year (often referred to as the 'integral approach') and, therefore, the said expense should be worked out on the basis of the estimated weighted average annual effective income-tax rate. According to this approach, the said rate is determined on the basis of the taxable income for the whole year, and applied to the accounting income for the interim period in order to determine the amount of tax expense for that interim period. This is in contrast to accounting for certain other expenses such as depreciation which is based on the approach prescribed in AS 25 that the interim period should be considered on stand-alone basis (often referred to as the 'discrete approach') because expenses such as depreciation are worked out on the basis of the period for which a fixed asset was available for use. The aforesaid treatments are, however, consistent with the requirement contained in paragraph 27 of AS 25

* Now Explanation to AS 22.

that an enterprise should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements.

GN(A) 28 Guidance Note on Applicability of AS 25 to Interim Financial Results

This Guidance Note deals with the issue whether Accounting Standard (AS) 25, Interim Financial Reporting, is applicable to interim financial results presented by an enterprise pursuant to the requirements of a statute/regulator, for example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises.

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise. For example, quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

GN(A) 29 Guidance Note on Turnover in Case of Contractors

This Guidance Note deals with the issue whether the revenue recognised in the financial statements of contractors as per the requirements of Accounting Standard (AS) 7, Construction Contracts (revised 2002), can be considered as 'turnover'.

The amount of contract revenue recognised as revenue in the statement of profit and loss as per the requirements of AS 7 (revised 2002), should be considered as 'turnover'.

Guidance Note on Schedule III to the Companies Act, 2013

The objective of this Guidance Note is to provide guidance in the preparation and presentation of Financial Statements of companies in accordance with various aspects of the Schedule III. However, it does not provide guidance on disclosure requirements under Accounting Standards, other pronouncements of the Institute of Chartered Accountants of India (ICAI), other statutes, etc.

Guidance Note on Accounting for Expenditure on Corporate Social Responsibility Activities.

The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure of expenditure on activities relating to corporate social responsibility.

The Guidance Note does not deal with identification of activities that constitute CSR activities but only provides guidance on accounting for expenditure on CSR activities in line with the requirements of the generally accepted accounting principles including the applicable Accounting Standards.

The Act clearly lay down that the expenditure on CSR activities is to be disclosed only in the Board's Report in accordance with the Rules made thereunder. In view of this, no provision for the amount which is not spent, i.e., any shortfall in the amount that was expected to be spent as per the provisions of the Act on CSR activities and the amount actually spent at the end of a reporting period, may be made in the financial statements. The proviso to section 135 (5) of the Act, makes it clear that if the specified amount is not spent by the company during the year, the Directors' Report should disclose the reasons for not spending the amount.

However, if a company has already undertaken certain CSR activity for which a liability has been incurred by entering into a contractual obligation, then in accordance with the generally accepted principles of accounting, a provision for the amount representing the extent to which the CSR activity was completed during the year, needs to be recognized in the financial statements.

Where a company spends more than that required under law, a question arises as to whether the excess amount 'spent' can be carried forward to be adjusted against amounts to be spent on CSR activities in future period. Since '2% of average net profits of immediately preceding three years' is the minimum amount which is required to be spent under section 135 (5) of the Act, the excess amount cannot be carried forward for set off against the CSR expenditure required to be spent in future.

A company may decide to undertake its CSR activities approved by the CSR Committee with a view to discharge its CSR obligation as arising under

section 135 of the Act in the following three ways:

(a) making a contribution to the funds as specified in Schedule VII to the Act; or

(b) through a registered trust or a registered society or a company established under section 8 of the Act (or section 25 of the Companies Act, 1956) by the company, either singly or along with its holding or subsidiary or associate company or along with any other company or holding or subsidiary or associate company of such other company, or otherwise; or

(c) in any other way in accordance with the Companies (Corporate Social Responsibility Policy) Rules, 2014, e.g. on its own.

In case a contribution is made to a fund specified in Schedule VII to the Act, the same would be treated as an expense for the year and charged to the statement of profit and loss. In case the amount is spent in the manner as specified in paragraph10 (b) above the same will also be treated as expense for the year by charging off to the statement of profit and loss. The accounting for expenditure incurred by the company otherwise e.g. on its own would be accounted for in accordance with the principles of accounting as explained hereinafter.

In case the expenditure incurred by the company is of such nature which may give rise to an 'asset', a question may arise as to whether such an 'asset' should be recognised by the company in its balance sheet. In this context, it would be relevant to note the definition of the term 'asset'.

Invariably future economic benefits from a 'CSR asset' would not flow to the company as any surplus from CSR cannot be included by the company in business profits in view of Rule 6(2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014.

In some cases, a company may supply goods manufactured by it or render services as CSR activities. In such cases, the expenditure incurred should be recognised when the control on the goods manufactured by it is transferred or the allowable services are rendered by the employees. The goods manufactured by the company should be valued in accordance with the principles prescribed in Accounting Standard (AS) 2, Valuation of Inventories. The services rendered should be measured at cost. Indirect taxes (like excise duty, service tax, VAT or other applicable taxes) on the goods and services so contributed will also form part of the CSR expenditure.

Where a company receives a grant from others for carrying out CSR activities, the CSR expenditure should be measured net of the grant.

Rule 6 (2) of the Companies (Corporate Social Responsibility Policy) Rules, 2014, requires that "the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a company". any surplus arising out of CSR project or programme or activities shall be recognised in the statement of profit and loss and since this surplus cannot be a part of business profits of the company, the same should immediately be recognised as liability for CSR expenditure in the balance sheet and recognised as a charge to the statement of profit and loss. Accordingly, such surplus would not form part of the minimum '2% of the average net profits of the company made during the three immediately preceding financial years in pursuance of its Corporate Social Responsibility Policy'.

It is recommended that all expenditure on CSR activities, that qualify to be recognised as expense in accordance with paragraphs 10-14 above should be recognised as a separate line item as 'CSR expenditure' in the statement of profit and loss. Further, the relevant note should disclose the break-up of various heads of expenses included in the line item 'CSR expenditure'.

Guidance Note on Accounting for Derivative Contracts.

The objective of this Guidance Note is to provide guidance on recognition, measurement, presentation and disclosure for derivative contracts so as to bring uniformity in their accounting and presentation in the financial statements. This Guidance Note also provides accounting treatment for such derivatives where the hedged item is covered under notified Accounting Standards, e.g., a commodity, an investment, etc., because except AS 11, no other notified Accounting Standard prescribes any accounting treatment for derivative accounting. This Guidance Note, however, does not cover foreign exchange forward contracts which are within the scope of AS 11. This Guidance Note is an interim measure to provide recommendatory guidance on accounting for derivative contracts and hedging activities considering the lack of mandatory guidance in this regard with a view to bring about uniformity of practice in accounting for derivative contracts by various entities.

This Guidance Note covers all derivative contracts that are not covered by an existing notified Accounting Standard. Hence, it does not apply to the following:

(i) Foreign exchange forward contracts (or other financial instruments which in substance are forward contracts covered) by AS 11.

(ii) Derivatives that are covered by regulations specific to a sector or specified set of entities.

The accounting for derivatives covered by this Guidance Note is based on the following key principles:

(i) All derivative contracts should be recognised on the balance sheet and measured at fair value.

(ii) If any entity decides not to use hedge accounting as described in this Guidance Note, it should account for its derivatives at fair value with changes in fair value being recognised in the statement of profit and loss.

(iii) If an entity decides to apply hedge accounting as described in this Guidance Note, it should be able to clearly identify its risk management objective, the risk that it is hedging, how it will measure the derivative instrument if its risk management objective is being met and document this adequately at the inception of the hedge relationship and on an ongoing basis.

(iv) An entity may decide to use hedge accounting for certain derivative contracts and for derivatives not included as part of hedge accounting, it will apply the principles at (i) and (ii) above.

(v) Adequate disclosures of accounting policies, risk management objectives and hedging activities should be made in its financial statements

Hedge accounting may be required due to accounting mismatches in:

- Measurement –
- Recognition

Types of hedge accounting

This Guidance Note recognises the following three types of hedging;

- the fair value hedge accounting model is applied when hedging the risk of a fair value change of assets and liabilities already recognised in the balance sheet, or a firm commitment that is not yet recognised.
- the cash flow hedge accounting model is applied when hedging the risk of changes in highly probable future cash flows or a firm commitment in a foreign currency.
- the hedge of a net investment in a foreign operation.

Derivative assets and liabilities recognised on the balance sheet at fair value should be presented as current and non-current.

Guidance Note on Accounting for Depreciation in Companies in the context of Schedule II to the Companies Act, 2013

This Guidance Note is issued with the objective to provide guidance on certain significant issues that may arise from the practical application of Schedule II with a view to establish consistent practice with regard to the accounting for depreciation.

This Guidance Note includes relevant provisions of Schedule II and provides guidance on implementing the requirements of Schedule II.

Schedule II to the Companies Act, 2013, specifies useful lives for the purpose of computation of depreciation. The said Schedule II was further amended by the Ministry of Corporate Affairs (MCA) through its notifications G.S.R. 237(E) dated March 31, 2014 and G.S.R. 627(E) dated August 29, 2014, respectively. As compared to Schedule XIV to the Companies Act, 1956, Schedule II, instead of specifying rates of depreciation for various assets, specifies that depreciation should be provided on the basis of useful life of an asset. While Schedule XIV was prescriptive in nature as it specified the minimum rate of depreciation, Schedule II provides indicative useful lives for various assets. As a consequence, the companies are in a position to charge depreciation based on the useful life of an asset supported by technical advice, even though such lives are higher or lower than those specified in the said schedule. In view of this, depreciation charged as per the useful life is true commercial depreciation bringing the financial statements prepared accordingly closer to those prepared in accordance with international standards.

the useful lives as given under Part 'C' of Schedule II for various types of assets are indicative only and are not minimum or maximum. Where the useful lives of various specific assets are the same as those under Schedule II, the company should use these useful lives. In case the useful life of an asset as estimated by the company, supported by the technical advice, external or internal, differs, i.e., higher or lower from the indicative useful life given under Schedule II, the former should be applied by the company for providing depreciation. The disclosures in this regard should be made as described later in this Guidance Note. The process of determination of useful life is explained in the chart below. A company has to determine the useful life at the beginning of the year for all fixed assets, existing as at the end of the immediately preceding period and for newly acquired assets, as and when acquired. All fixed assets existing at the beginning of the year should be classified into assets for which no extra shift depreciation is applicable which would include continuous process plant (CPP) and assets for which extra shift depreciation applies. Of the assets for which extra shift depreciation applies, assets which are going to be used on single shift, double shift or triple shift are segregated. This segregation is required as the extra shift depreciation is applicable only to those assets whose useful life is determined on single shift basis. After segregation, the remaining useful life of the asset is estimated. A company recognises depreciation expense based on the useful life estimated by the management. Where the useful life estimated by the management is different from that specified by Schedule II, the same is disclosed in notes.

Illustration

A Limited is a company incorporated under the Companies Act, 1956, engaged in the business of manufacturing of toys. A Limited purchased a unit of machinery costing ₹ 60 lakhs as on April 01, 2014. As per Schedule II the general useful life of the assets is15 years. However, as per A Ltd.'s estimation, the useful life of the asset is 20 years supported by the technical advice.

Should the company use the useful life as 15 years or 20 years?

Solution

In this case, keeping in view the requirements under Schedule II, A Ltd. should depreciate the machinery over its useful life of 20 years as determined by the company and not over 15 years as indicated in Schedule II. A limited should also provide disclosures in this regard as recommended later in this Guidance Note in the notes to accounts to justify the reason for difference between the indicative use life and A's estimated useful life.

Illustration

B Limited had considered the minimum rates of depreciation mentioned in Schedule XIV for depreciating all its fixed assets till March 31, 2014. Based on the rates mentioned for SLM and WDV in Schedule XIV, B Limited had derived the useful lives for the assets. Schedule II of the Companies Act, 2013 is now applicable to B Limited w.e.f. April 1, 2014.

Whether B Limited needs to follow the useful lives mentioned in the Schedule II or derived useful lives considered till March 31, 2013 can be considered?

Solution

W.e.f. April 1, 2014, B limited should estimate the remaining useful lives of its assets based on the definition of useful life in Schedule II and the factors specified in AS 6 for recognising depreciation in the statement of profit and loss. There is no relevance of the derived useful life as per Schedule XIV. However, if B Limited estimates useful lives different from those specified in Schedule II, it should disclose such differences in the financial statements and provide justification in this behalf duly supported by technical advice.

Note 8 to Schedule II defines the expression 'Continues Process Plant' as:

''Continuous process plant'' means a plant which is required and designed to operate for twenty-four hours a day.

The words "required and designed to operate twenty-four hours a day" are very significant and should be interpreted with reference to the inherent technical nature of the plant, i.e., the technical design of a CPP is such that there is a requirement to run it continuously for twenty-four hours a day. If it is not so run, there are significant shut-down and/or start-up costs. If such a plant is shut-down, there may be significant spoilage of materials-in-process/ some damage to the plant itself/significant energy loss. It is, however, possible that due to various reasons, e.g., lack of demand, maintenance etc., such a plant may be shut down for some time. The shut-down does not change the inherent technical nature of the plant.

CPP is distinct from the repetitive process plant or assembly-line type plants. These plants are not CPP since such plants do not involve significant shut-down and/or start-up costs and are not technically required and designed to operate twenty-four hours a day, e.g., an automobile manufacturing plant.

It is noted that extra shift depreciation does not apply to CPP and the assets which have been marked as No Extra Shift Depreciation (NESD) under Schedule II. The concept of extra shift depreciation applies only to those assets for which the useful life has been estimated on single shift basis at the beginning of the year

Where a company, which estimated the useful life of an asset on single shift basis at the beginning of the year, used the asset on double or triple shifts during the year, the depreciation expense should be increased by 50% or 100% as the case may be for that period. Further, for such assets, the company at the beginning of the next year should determine whether the asset used in extra shift during the past year was on sporadic basis and is expected to be used on sporadic basis in future also. In such a case, the useful life to be on single shift basis and if in future the asset is used on double or triple shift then as in the past, the depreciation expense for the double or triple shift should be increased by 50% or 100% as the case may be for the period of use. In case the company estimates that the use of the asset for extra shift would not be on sporadic basis i.e. the extra shift working for the asset would be on regular or continuous basis, it should reassess its useful life considering its use on extra shift basis. The reassessed useful life should then be used for the purpose of charging depreciation expense henceforth.

a result of application of Schedule II, a company may use UOP method, where appropriate, keeping in view the various factors mentioned in paragraph 12 of AS 6. UOP method is generally considered appropriate where the number of units that can be produced or serviced from the use of the asset is the major limiting factor for the use of the asset rather than the time.

with the introduction of UOP method in Schedule II, a company may change from SLM or WDV method to UOP method. In such cases, in accordance with AS 6, depreciation on the underlying asset should be calculated retrospectively using the UOP method from the date the asset came into use to the company with adjustment of any surplus or deficiency arising from change in method to the statement of profit and loss as such change is required by the statute. However, as a first time application of Schedule II, if a company changes its method of depreciation from WDV to SLM or vice versa, the same cannot be justified as required by law as both the methods were allowed under Schedule XIV and AS 6. In accordance with AS 6, a shift from WDV to SLM or vice versa can only be applied by the company if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the company. In such a case also, any surplus or deficiency arising from change in method should be adjusted to the statement of profit and loss in accordance with AS 6. It may also be noted that in case of change in method of depreciation, transitional provisions given under Note 7 (b) of Schedule II will not apply.

Illustration:

A Limited is a company incorporated under the Companies Act and engaged in the business of oil exploration. Keeping in view the requirement in Schedule XIV it was depreciating its oil and gas assets on

SLM basis. In the financial year 2014-15, when A applies Schedule II it decides to depreciate the said assets by following the UOP method.

How should change in method be accounted for?

Solution

In this case, in accordance with AS 6, A Limited should calculate depreciation on all such assets following the UOP method since the assets came into existence and recognise any deficiency/gain in the statement of profit and loss for the period ending on March 31, 2015.

Useful life specified in Part C of the Schedule is for whole of the asset. Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately. It is commonly known as 'component accounting'. Companies will need to identify and depreciate significant components with different useful lives separately.

Under component accounting, companies will capitalise these costs as a separate component of the asset and decapitalise the carrying amount of previously recognised component. A company is required to apply component accounting (if appropriate) for all depreciable fixed assets (existing or newly acquired) as at 1 April 2014 if a company opts to follow it voluntarily and as at 1 April, 2015 mandatorily. However, if the carrying amount of any asset is lower than or equal to the estimated residual value of the asset(s), company is not required to apply component accounting for such asset(s).

The company must split the fixed asset into various identifiable parts to the extent possible. The identified parts should be grouped together if they have the same or similar useful life for the purpose of separate depreciation. Insignificant parts may be combined together in the remainder of the asset or with the principal asset.

It may be noted that Schedule II does not prescribe any such requirement to provide depreciation at the rate of hundred percent. Therefore, an issue may arise whether the earlier requirement of providing hundred percent depreciation on assets with value less than rupees five thousand can still be followed or not.

As the life of the asset is a matter of estimation, the materiality of impact of such charge should be considered with reference to the cost of asset. The size of the company will also be a factor to be considered for such policy. Accordingly, a company may have a policy to fully depreciate assets upto certain threshold limits considering materiality aspect in the year of acquisition.

The company may group additions and disposals in appropriate time period(s), e.g., 15 days, a month, a quarter etc., for the purpose of charging pro rata depreciation in respect of additions and disposals of its assets keeping in view the materiality of the amounts involved.

The use of different methods for similar assets at different geographical locations is not justified.

29.5 Miscellaneous Illustrations

Illustration 1

HSL Ltd. is manufacturing goods for local sale and exports. As on 31st March, 2017, it has the following finished stocks in the factory warehouse:

(i) Goods meant for local sale ₹ 100 lakhs (cost ₹ 75 lakhs).

(ii) Goods meant for exports ₹ 50 lakhs (cost ₹ 20 lakhs).

Excise duty is payable at the rate of 16%. The company's Managing Director says that excise duty is payable only on clearance of goods and hence is not a cost. Please advise HSL using guidance note, if any issued on this, including valuation of stock.

Solution

Guidance Note on Accounting Treatment for Excise Duty says that excise duty is a duty on manufacture or production of excisable goods in India.

According to Central Excise Rules, 2002, excise duty should be collected at the time of removal of goods from factory premises or factory warehouse. The levy of excise duty is upon the manufacture or production, the collection part of it is shifted to the stage of removal.

Further, paragraph 23(i) of the Guidance Note makes it clear that excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.

Therefore, in the given case of HSL Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 16% on the selling price, that is, ₹ 100 lakhs for valuation of stock.

Excise duty on goods meant for exports, should be provided for, since the liability for excise duty arises when the manufacture of the goods is completed. However, if it is assumed that all the conditions specified in Rule 19 of the Central Excise Rules, 2002 regarding export of excisable goods without payment of duty are fulfilled by HSL Ltd., excise duty may not be provided for.

Illustration 2

A factory went into commercial production on 1st April, 2017. It uses as its raw materials product X on which excise duty of ₹ 30 per kg. is paid and product Y on which excise duty of ₹ 20 per kg. is paid. On 31st March, 2017 it had stock of 20,000 kgs. of X and 15,000 kgs. of Y which it had purchased at an all inclusive price of ₹ 150 per kg. for X and ₹ 120 per kg. for Y. The suppliers of X and Y are to receive payment on 15th May, 2017.

During April 2017, the factory manufactured 40,000 units of the end product for which the consumption of material X was 60,000 kgs. and material Y was 45,000 kgs. The excise duty on the end product is ₹ 60 per unit. 30,000 units of the end product were dispatched, 8,000 units were kept in warehouse and balance 2,000 kgs. were kept in finished goods godown.

During the month the factory purchased 50,000 kgs. of X at ₹ 145 per kg. (inclusive of excise duty of ₹ 30 per kg.) on credit of 60 days and 50,000 kgs. of Y at ₹ 110 per kg. (inclusive of excise duty of ₹ 20 per kg.) on credit of 45 days.

The cost of "converting" the raw materials into finished product amounts to ₹ 150 per unit of end product of which ₹ 100 is "cash cost" paid immediately and ₹ 50 represents non-cash charge for depreciation. There is no work in process.

Sales are effected at ₹ 750 per unit in respect of credit transactions and at ₹ 700 per unit in respect of cash transactions. 20% of dispatches were in respect of cash transactions while the balance 80% were in respect of credit transactions (one month credit).

You are required to:

(a) (i) Calculate MODVAT credit available, MODVAT credit availed of and balance in MODVAT credit as on 30th April, 2017.

(ii) Show the necessary ledger accounts in respect of MODVAT.

(b) Value the inventory of:

(i) raw material

(ii) finished goods in warehouse

(iii) finished goods in finished goods godown on "first in first out" principle.

(c) Show the ledger accounts of customers, suppliers and bank, assuming that the necessary bank balance is available at the start of the month to meet "cash" expenses of that month.

(d) Calculate the working capital as on 30th April, 2017.

(e) State the impact of 'MODVAT' on working capital requirement of the factory as on 30th April, 2017.

Solution

(a) (i) Excise duty paid on raw materials:

	X			*Y*			*Total*
	kgs.	*@*	*Amount ₹*	*kgs.*	*@*	*Amount ₹*	*Amount ₹*
Stock on 31st March, 2017	20,000	30	6,00,000	15,000	20	3,00,000	9,00,000
Purchases	50,000	30	15,00,000	50,000	20	10,00,000	25,00,000
			21,00,000			13,00,000	34,00,000

MODVAT credit available:

₹ 21,00,000 + 13,00,000 = ₹ 34,00,000

MODVAT credit availed of:

Production = 40,000 units

Excise duty on the end product = ₹ 60 per unit

MODVAT credit availed of = 40,000 × 60 = ₹ 24,00,000

Balance in MODVAT credit 34,00,000 – 24,00,000 = ₹ 10,00,000

Note: Normally goods are removed from factory on payment of excise duty. However, in respect of certain goods, provision has been made to store the goods in warehouses without payment of duty (Rule 20 of Central Excise Rules, 2002). These provisions are also applicable to goods transferred to customs warehouse.

It is to be noted that as per para 33 of The Guidance Note on Accounting Treatment for Excise Duty, it is necessary that a provision for liability in respect of unpaid excise duty should be made in the accounts in respect of stocks lying in the factory or warehouse since the liability for excise duty arises when the manufacture of the goods is completed.

(ii) MODVAT Credit Receivable Account

2015			₹	*2015*		₹
April 1	To Balance b/d			April	By Excise Duty A/c	24,00,000
	X	6,00,000		1 to 30		
	Y	3,00,000				
			9,00,000	April 30	By Balance c/d	10,00,000
April 1	To Suppliers A/c					
to 30	X	15,00,000				
	Y	10,00,000				
			25,00,000			
			34,00,000			34,00,000

Purchases Account

2015		₹	*2015*		₹
April	To Suppliers A/c		April 30	By Balance c/d	1,02,50,000
1 to 30	X: [50,000 × (145 – 30)]	57,50,000			
	Y: [50,000 × (110 – 20)]	45,00,000			
		1,02,50,000			1,02,50,000

(b) Valuation of Inventory

(i) Raw material:

	X (Kgs.)	*Y* (Kgs.)
Opening stock	20,000	15,000
Purchases	50,000	50,000
	70,000	65,000
Consumption	60,000	45,000
Closing stock	10,000	20,000
Inventory:		₹
X : 10,000 × (145 – 30)		11,50,000
Y : 20,000 × (110 – 20)		18,00,000
		29,50,000

(ii) Finished goods in warehouse

		₹
Raw material cost of 8,000 units of output		
X : 12,000* × (145 – 30)	13,80,000	
Y : 9,000* × (110 – 20)	8,10,000	21,90,000
Conversion cost		
Cash cost : 8,000 × ₹ 100	8,00,000	
Non-cash : 8,000 × ₹ 50	4,00,000	12,00,000
Excise duty		
8,000 × ₹ 60		4,80,000
		38,70,000

* For 40,000 units of output,

Input of X = 60,000 Kgs.

Input of Y = 45,000 Kgs.

Therefore, for 8,000 units of finished goods in warehouse:

Input of X = $\frac{60,000}{40,000} \times 8,000 = 12,000$ Kgs.

Input of Y = $\frac{45,000}{40,000} \times 8,000 = 9,000$ Kgs.

(iii) Finished goods in finished goods godown

	₹
Cost of 8,000 units of finished goods in warehouse	38,70,000
Cost of 2,000 units of finished goods in finished goods godown $= \frac{38,70,000}{8,000} \times 2,000$	9,67,500

(c) Customers Account

	₹		₹
To Sales A/c $\left(\frac{80}{100} \times 30,000 \times 750\right)$	1,80,00,000	By Balance c/d	1,80,00,000
	1,80,00,000		1,80,00,000

Suppliers Account

	₹		₹
To Balance c/d	1,75,50,000	By Balance b/d	
		X : 20,000 × ₹ 150 = 30,00,000	
		Y : 15,000 × ₹ 120 = 18,00,000	48,00,000
		By Purchases A/c	1,02,50,000

		By Modvat Credit Receivable A/c X : 50,000 × 30 = 15,00,000 Y : 50,000 × 20 = 10,00,000	25,00,000
	1,75,50,000		1,75,50,000

Bank Account

	₹		₹
To Balance b/d	40,00,000	By Cash Expenses (40,000 × 100)	40,00,000
To Sales (cash sales) A/c $\left(\frac{20}{100} \times 30,000 \times ₹\ 700\right)$	42,00,000	By Balance c/d	42,00,000
	82,00,000		82,00,000

(d) Working Capital as on 30th April, 2017

Current Assets:

Inventory

(i)	Raw materials		
	X	11,50,000	
	Y	18,00,000	29,50,000
(ii)	Finished goods in warehouse	38,70,000	
	in finished goods godown	9,67,500	48,37,500
Customers			1,80,00,000
Bank balance			42,00,000
MODVAT credit receivable			10,00,000
			3,09,87,500
Less: Current Liabilities			
Sundry creditors			(1,75,50,000)
			1,34,37,500

(e) Impact of Modvat on Working Capital Requirement

Modvat has enabled

(i) dispatch on sale of 30,000 units of finished product,

(ii) removal of 10,000 units of finished product, without payment of a single rupee in cash. Cash outlay so saved at ₹ 60 per unit is ₹ 24,00,000.

It has also ensured creation of a current asset worth ₹ 10,00,000 in MODVAT Credit Receivable Account. Thus, MODVAT reduces the pressure on working capital.

Illustration 3

Vikas Ltd. purchased a plant for ₹ 50 lakhs from Yash Ltd. during 2015 - 2016 and installed immediately. The price includes excise duty of ₹ 5 lakhs. During 2015 - 2016, the company produced excisable goods on which the excise authority charged excise duty to the extent of ₹ 4.5 lakhs. Show

the necessary Journal Entries explaining the treatment of CENVAT credit. You are also required to indicate the value of plant at which it should be recorded in Fixed Asset register.

Answer

(i) Journal Entries

			₹ in lakhs	
(a)	Plant and Machinery A/c	Dr.	45	
	CENVAT credit receivable on capital goods A/c	Dr.	5	
	To Bank A/c or Yash Ltd.			50
	(Being capitalization of plant and machinery)			
(b)	Excise duty A/c	Dr.	2.5	
	To CENVAT credit receivable on capital goods A/c			2.5
	(Being excise duty set off available to the extent of 50% in the first year of acquisition of capital asset)			

(ii) Value of plant to be recorded in Fixed Asset Register: As per Guidance Note on "Accounting Treatment for CENVAT", fixed assets have to be capitalised net of refundable amounts.

The plant and machinery will be recorded at ₹ 45 lakhs (₹ 50 lakhs - ₹ 5 lakhs) in the fixed asset register.

Illustration 4

A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 2016, it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130. The options were to be exercised between 16th December, 2016 and 15th March, 2017. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

Journal Entries

2016	*Particulars*		*Dr.* ₹	*Cr.* ₹
April 1	Employee Compensation Expense	Dr.	9,00,000	
	To Employee Stock Options Outstanding			9,00,000
	(Being grant of 10,000 stock options to employees at ₹ 40 when market price is ₹ 130)			
2017				
16th Dec.	Bank	Dr.	3,80,000	
to 15th	Employee stock options outstanding	Dr.	8,55,000	
March	To Equity share capital			95,000

	To Securities premium			11,40,000
	(Being allotment to employees of 9,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share in exercise of stock options by employees)			
March 16	Employee stock options outstanding	Dr.	45,000	
	To Employee compensation expense			45,000
	(Being entry for lapse of stock options for 500 shares)			
March 31	Profit and Loss A/c	Dr.	8,55,000	
	To Employee compensation expense			8,55,000
	(Being transfer of employee compensation expense to profit and loss account)			

Illustration 5

Mr. Investor buys a stock option of ABC Co. Ltd. in July, 2017 with a strike price ₹ 250 to be expired on 30th August, 2017. The premium is ₹ 20 per unit and the market lot is 100. The margin to be paid is ₹ 120 per unit.

Show the accounting treatment in the books of Buyer when:

(i) the option is settled by delivery of the asset, and

(ii) the option is settled in cash and the Index price is ₹ 260 per unit.

Solution

Accounting entries in the books of buyer

			₹	₹
July, 2017	Equity stock option premium Account	Dr.	2,000	
	To Bank Account			2,000
	(Being premium paid to acquire stock option)			
	Equity Stock Option Margin Account	Dr.	12,000	
	To Bank Account			12,000
	(Being initial margin paid on option)			
	(i) Option is setted by delivery of assets			
August, 2017	Equity shares of ABC Ltd. Account	Dr.	25,000	
	To Equity Stock Option Margin Account			12,000
	To Bank Account			13,000
	(Being option exercised and shares acquired. Margin adjusted and the balance amount was paid)			
	Profit and loss Account	Dr.	2,000	
	To Equity Stock Option Premium Account			
	(Being the premium transferred to profit and loss account on exercise of option)			

	Bank Account Dr. To Equity Stock Option Margin Account (Being margin on equity stock option received back on exercise /expiry of option)	12,000	 12,000

Illustration 6

H Ltd. engaged in the business of manufacturing lotus wine. The process of manufacturing this wine takes around 18 months. Due to this reason H Ltd. has prepared its financial statements considering its operating cycle as 18 months and accordingly classified the raw material purchased and held in stock for less than 18 months as current asset. Comment on the accuracy of the decision and the treatment of the asset by H Ltd., as per the Schedule III.

Solution

As per Schedule III to the Companies Act, 2013, one of the criteria for classification of an asset as a current asset is that the asset is expected to be realised in the company's' operating cycle or is intended for sale or consumption in the company's normal operating cycle.

Further, Schedule III to the Companies Act, 2013 defines that an operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. However, when the normal operating cycle cannot be identified, it is assumed to have duration of 12 months.

As per the facts given in the question, the process of manufacturing of lotus wine takes around 18 months; therefore, its realisation into cash and cash equivalents will be done only when it is ready for sale i.e. after 18 months. This means that normal operating cycle of the product is 18 months. Therefore, the contention of the company's management that the operating cycle of the product lotus wine is 18 months and not 12 months is correct.

Illustration 7

Combine Ltd. is a group engaged in manufacture and sale of industrial and consumer products. One of its division deals with the real estate. The real estate division is continuously engaged in leasing of real estate properties. The accountant showed the rent arising from leasing of real estate as 'other income' in the Statement of Profit and Loss. State, whether the classification of the rent income made by the accountant is correct or not in light of Schedule III to the companies Act, 2013?

Solution

As per para 4 of the 'General Instructions for preparation of Statement of Profit and Loss' given in the Schedule III to the Companies Act, 2013, 'other income' does not include operating income. However, rent income arising from leasing of real estate properties is an operating income as Real Estate is one of the divisions of Combine Ltd. There is a separate head for operating income i.e. 'Revenue from Operations'. Therefore, classification of rent income as 'Other income' in the Statement of Profit and Loss will not be correct. It would, infact, be shown under the heading 'Revenue from Operations' only.

Illustration 8

Presented below is an extract of the Schedule of Secured and Unsecured Loans of Annual Report 2016-2017 of Super Star Ltd.

Particulars	*Schedule No*	*As at 31st March, 2017 (₹)*
Loan Funds		
a) Secured Loans	*3*	*6,07,114*
b) Unsecured Loans - Short Term Banks		*36,112*
		6,43,226
Schedule 3: Secured Loans		
Term Loans from:		
- Banks		*2,95,002*
- Others		*3,12,112*
		6,07,114

Other Information:

Current maturities of long-term loan from bank *₹ 30,000*

Current maturities of long-term loan from other parties *₹ 15,376*

There was no interest accrued/due as at end of the year.

Prepare appropriate note to accounts complying with the requirements of Schedule III to the Companies Act, 2013 on the basis of available information.

Solution

Balance Sheet of Super Star Ltd.
As on 31st March, 2017

Particulars	Note No	Amount
Non Current Liabilities		
Long term borrowings	4	5,61,738
Current Liabilities		
Short term borrowings	5	36,112
Other current liabilities	6	45,376
		6,43,226

Notes to Accounts

4. Long-Term Borrowings	
Term loans – Secured	
- from banks	2,95,002
- from other parties	3,12,112
	6,07,114

	Less : Shown in current maturities of long-term debt (Refer Note 6)	(45,376)
		5,61,738
5.	Short-Term Borrowings	
	(Unsecured – payable on demand)	
	- from bank	36,112
6.	Other Current Liabilities	
	Current maturities of long-term debt	
	From banks	30,000
	From other	15,376
		45,376

It is assumed the Note 1 is for 'Significant Accounting Policies', Note 2 for 'Share Capital', Note 3 for 'Reserves and Surplus'.

Illustration 9

Astha Ltd. has FCCBs worth ₹ 100 crore which are due to mature on 31st December 2016. While preparing the financial statements for the year ending 31st March 2016, it is expected that the FCCB holders will not exercise the option of converting the same to equity shares. How should the company classify the FCCBs on 31st March 2016? Will your answer be different if the company expects that FCCB holders will convert their holdings into equity shares of Astha Ltd.?

Solution

Schedule III to the companies Act, 2013 provides that:

"A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments and do not affect its classification."

In the present situation, Astha Ltd. does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date. The position will be same even when the FCCB holders are expected to convert their holdings into equity shares of Astha Ltd. Expectations cannot be called as unconditional rights. Thus, in both the situations, Astha Ltd. should classify the FCCBs as current liabilities as on 31 March 2016.

Illustration 10

The Balance Sheet of Appropriate Ltd. as at 31st March, 2016 is as follows:

	Note No.	*31st March, 2016*	*31st March, 2015*
Equity & Liabilities			
Share Capital	1	XXX	XXX
Reserves and Surplus	2	0	0
Employee stock option outstanding	3	XXX	XXX
Share application money refundable	4	XXX	XXX
Non-Current Liabilities			
Deferred tax liability (Arising from Indian Income Tax)	5	XXX	XXX
Current Liabilities			
Trade Payables	6	XXX	XXX
Total		XXXX	XXXX
Assets			
Non-Current Assets			
Fixed Assets -Tangible	7	XXX	XXX
Capital Work in progress (including capital advances)	8	XXX	XXX
Current Assets			
Trade Receivables	9	XXX	XXX
Deferred Tax Asset (Arising from Indian Income Tax)	10	XXX	XXX
Profit and Loss (Debit balance)		XXX	XXX
Total		XXXX	XXXX

Comment on the presentation in terms of Schedule III to the Companies Act, 2013 and Accounting Standards notified by the Central Government.

Solution

(1) Share Capital' and 'Reserves and Surplus' are required to be shown under the heading "Shareholders' funds", which have not been shown in the given balance sheet. Although it is a part of 'Equity and Liabilities' yet it must be shown under the head "Shareholders' Funds". The heading "Shareholders' Funds" is missing in the balance sheet given in the question.

(2) Reserves & Surplus is showing zero balance, which is not correct since there is. Debit balance of Statement of Profit & Loss. This debit balance of Profit and Loss should be shown as a negative figure under the head 'Surplus'. The balance of 'Reserves and Surplus', after adjusting negative balance of surplus shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative. It should be noted that Profit and Loss Debit Balance is not a part of current assets rather debit balance of Statement of Profit and Loss shall be shown as a negative figure under the head 'Surplus' as per requirement of Schedule III to the Companies Act, 2013.

(3) As per Schedule III to the Companies Act, 2013, Employee Stock Option Outstanding A/c is part of Reserves and Surplus and should not be shown separately. Classification of Reserves and Surplus should be reflected is 'Notes to Accounts' for the same.

(4) Share application money refundable shall be shown by way of note under the sub-heading "Other Current Liabilities". As this is refundable and not pending for allotment, hence it is not a part of equity.

(5) Deferred Tax Liabilities has been correctly shown under Non-Current Liabilities. But Deferred tax assets and deferred tax liabilities, both, can not be shown in balance sheet because only the net balance of Deferred Tax Liabilities or Asset is to be shown as per para 29 of AS 22, Appropriate Ltd. should offset Deferred Tax Asset & Deferred Tax Liabilities and the break up of Deferred Tax Asset & Deferred Tax Liabilities into major components of the respective balance should be disclosed in 'Notes to Account'. Deferred Tax Asset shall be shown under Non-current Asset. It should be the net balance of Deferred Tax Asset after adjusting the balance of deferred tax liability.

(6) Under the main heading of Non-Current Assets, Fixed Assets are further classified as under:

(i) Tangible assets

(ii) Intangible assets

(iii) Capital work in Progress

(iv) Intangible assets under development.

Keeping in view the above, the Capital Work-in Progress shall be shown under Fixed Assets as Capital Work in Progress. The amount of Capital advances included in CWIP shall be disclosed under the sub-heading "Long term loans and advances" under the heading Non-Current Assets.

Reference: The students are advised to refer the full text of relevant Guidance Notes.