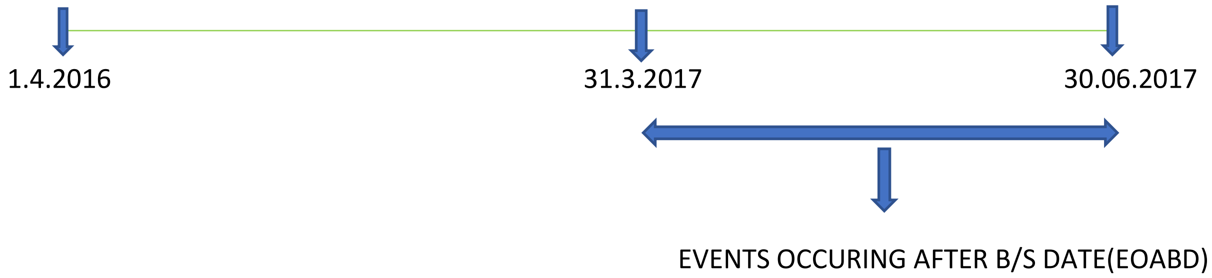
AS-4: CONTINGENCIES & EVENTS OCCURING AFTER THE BALANCE SHEET DATE

CA. TEJAS SUCHAK

EVENTS OCCURING AFTER THE BALANCE SHEET DATE

- Are those significant events,
- both favourable & unfavourable,
- that occur between the b/s date & the date when fin. stat. are approved by the BoD.



EOABD ARE OF TWO TYPES

ADJUSTING EVENTS

DEFINITION: Adjusting events are those events that provide further evidence relating to conditions that existed at B/S date.

TREATMENT: Assets & Liabilities are required to be adjusted for events that;
a) Provide additional information relating to conditions that existed at B/S date.
b) Materially affect determination of amounts relating to conditions that existed on B/S date.
NOTE: Assets & Liabilities are required to be adjusted for the following:
-When the GOING CONCERN assumption is in doubt.
-When there is a STATUTARY REQUIRMENT. Eg: Proposed Dividend.

NON-ADJUSTING EVENTS

DEFINITION: Non-adjusting events are those events that are not related to conditions that existed at B/S date.

Such conditions arose subsequent to the B/S date.

TREATMENT: Do not account/adjust in Financial statements.

Only DISCLOSURE in the report of the approving authority is required.

Following two things need to be disclosed:

a) Nature of the event.
b) Estimate of the financial effect or the fact that such estimate cannot be made.

NOTE: Clauses of Contingencies stand withdrawn from AS-4 and the same will be covered under AS-29: Provisions, contingent Liabilities & Contingent Assets.

AS-4: CONTINGENCIES & EVENTS OCCURING AFTER B/S DATE

CA TEJAS SUCHAK
ACCOUNTANCY ACE

QUESTION 1

Balakumara Ltd invested Rs. 100 Lakhs in April, in the acquisition of another Company doing similar business, the negotiations for which had started during the Financial Year just ended on 31st March. How will this be treated in the final accounts for the year just ended?

The negotiation with another Company for acquisition of its business was started on 2nd February. Pradeep Ltd invested Rs. 40 Lakhs on 12th April (next Financial Year).

*• The acquisition of another Company is an event occurring **after** the Balance Sheet date.*

*• However, **no adjustment to assets and liabilities** is required, as the event **does not** affect the determination and the condition of the amounts stated in the Financial Statements for the year ended 31st March. The same may however be disclosed in the report of the **Board of Directors.***

QUESTION 2

The terms and conditions for acquisition of business of another Company have been decided by March end. But the financial resources were arranged in April and amount invested was Rs. 40 Lakhs. Is this an Adjusting Event?

*• Terms and Conditions for acquisition of Business of another Company have **only** been decided before B/s date, but actual transaction has **not** taken place. It is presumed that neither party has finalized its intention for the transaction.*

*• Hence, it is a **Non-Adjusting Event.** Disclosure in Board's Report is required for material changes, affecting the financial position of the Entity.*

Defalcation of Cash during Financial Year - Detection Post B/s date

QUESTION 3

In Yogeswar Ltd, theft of cash of Rs. 2 Lakhs by the Cashier in January was detected in May. The accounts of the Company were not yet approved by the Board of Directors of the Company. Whether the theft of cash has to be adjusted in the accounts of the Company for the year ended 31st March. Decide.

• Theft of Cash took place in January, and hence such condition already existed on Balance Sheet Date.

*• So, detection of the loss in May is an **adjusting event** and should be adjusted in the accounts of the Company for the*

year ended 31st March.

QUESTION 4

Cashier of Subramanya Limited embezzled Cash amounting to Rs. 6,00,000 during March. However, the same comes to the notice of the Company's Management during April only. Financial Statements of the Company is not yet approved by the Board of Directors of the Company. With the help of provisions of AS - 4 decide, whether the embezzlement of cash should be adjusted in the books of accounts for the year ending 31st March?

***What will be your reply, if embezzlement of cash comes to the notice of Company Management, only after approval of Financial Statements by the Board of Directors of the Company?** • Theft of Cash took place in March and hence such condition already existed on the Balance Sheet date. Detection of this embezzlement in April is an **adjusting event,** and should be adjusted / written off in the accounts for the year ending 31st March.*

• *In case the theft of Cash came to light only **after** approval of Financial Statements, it should be adjusted as a **Prior Period Item** in the next financial year, relating to omission of embezzlement item during the previous financial year.*

QUESTION 5

A Company deals in petroleum products. The sale price of petrol is fixed by the Government. After the Balance Sheet date, but before the finalization of the Company's accounts, the Government unexpectedly increased the price retrospectively. Can the Company account for additional revenue at the close of the year? Discuss.

*1. **Principle:** Adjusting Events are those significant events, which provide additional information materially, affecting the determination of the amounts relating to conditions existing at the Balance Sheet date. Here, price revision is an **Adjusting Event,** since sale had already taken place during the Financial Year.*

*2. **Nature of Price Revision:** The Price Revision is granted during the current accounting period, i.e. after the Balance Sheet date, but before finalization of accounts. This is **not** a Prior Period Item as per AS - 5, as there is no error or omission in the past financial year.*

*3. **Revenue Recognition:** As per Para 10 of AS - 9, if the Company is able to assess the ultimate collection with reasonable certainty, then additional revenues arising out of the said price revision may be recognised in the current financial year.*

Estimation of Additional Expenses

QUESTION 6

Siddha Ltd entered into an agreement to sell its Immovable Property included in the Balance Sheet at Rs. 7 Lakhs to another Company for Rs. 35 Lakhs. The agreement to sell was concluded on 31st January but the Sale Deed was registered only on 30th April. The Company's accounting year ended on 31st March and the accounts for that period were considered and approved by the Board of Directors on 15th May. How will you treat the above in the accounts for the year ended 31st March?

1. Substance Over Form:

*(a) The asset has been **"SOLD"** before the Balance Sheet date, as evidenced by the execution of sale deed and handing over of possession of the property.*

*(b) The agreement to sell was **"concluded"** on 31st January, i.e. during the Financial Year. The significant risks and rewards relating to ownership had passed to the Buyer before the Balance Sheet date. Where consideration is paid to the Seller and possession of the property is handed over to the Buyer, even if the Sale Deed has not been registered, Sec 53A of the Transfer of Property Act will be applicable.*

(c) Therefore, the transaction of sale has already taken place before the Balance Sheet date, and hence should be recorded in the statement of accounts immediately.

(d) Registration of the "Sale Deed" is only a legal formality, to lend further sanction to the transaction, and not determinant of whether sale has taken place or not, in the given case.

*2. **After Balance Sheet Date Event:** The formal registration of deed of sale, is an event after the Balance Sheet date, which confirms the legal part of the transaction which should already be recorded in the Financial Statements.*

*3. **Conclusion:** Hence, necessary adjustment should be made to the assets and liabilities at the Balance Sheet Date. The sale and the gain thereon should be recognized in the accounts for the year ended 31st March.*

Registration After Balance Sheet Date

QUESTION 7

Muruga Ltd sends a proposal to purchase an Immovable Property for Rs. 30 Lakhs in March. The Book Value of the Property is Rs. 20 Lakhs as on year end date. However, the Deed was registered as on 15th April. How will you treat the above in the accounts for the year ended 31st March?

• Only Proposal is sent as on B/s dated 31st March and the Sale (Registration of Deed) is completed on 15th April.

• As on the B/s date, neither the possession of the Property is handed over to the Buyer nor has the Buyer paid entire amount to the Seller. So, it is a ***Non-Adjusting Event.***

QUESTION 8

Advise Dhandapani Ltd about the treatment of the following in the final statement of accounts for the year ended 31st March. On 15th April, due to destruction of the Factory by fire, X, one of the Company's Debtors, declared himself insolvent. He owed Rs. 1,17,000 to Dhandapani Ltd.

1. ***Principle:*** *Adjustment may be made for a loss on a Trade Receivable Account, which is confirmed by the insolvency of a customer, which occurs after the Balance Sheet date.*

2. ***Conclusion:*** *Hence, adequate* **Provision for Bad Debts** *should be created to cover the loss arising out of such insolvency, in the accounts for the year ended 31st March.*

Note: *If Fire occurs after the B/s Date, then it does not reflect conditions existed at the Balance Sheet date. Hence, in such case, only disclosure is necessary as regards the irrecoverability of Sundry Debtors.*

QUESTION 9

While finalising the accounts for the year ended 31st March, Krithika Ltd made a Provision for Bad Debts at 5% of its Debtors. In the last week of February, a Debtor for Rs. 2,00,000 had suffered heavy loss due to an earthquake, the loss was not covered by any insurance policy. In April, the Debtor became bankrupt. Can the Company provide for full loss arising out of insolvency of the Debtor in the final accounts for the year ended 31st March?

Guha Ltd could not recover Rs. 10 Lakhs from a Debtor. The Company is aware that the Debtor is in great financial difficulty. The accounts of the Company were finalized for the year ended 31st March by making a provision at 20% of the amount due from the said Debtor. The Debtor became bankrupt in April and nothing is recoverable from him. Do you advise the Company to provide for the entire loss of Rs. 10 Lakhs for the year ended 31st March?

1. ***Analysis:*** *Here, the Debtor suffered the loss in February, and the circumstances were existing as on the Balance Sheet Date. The fact of bankruptcy in April only confirms the circumstances that existed on the Balance Sheet Date.*

2. ***Conclusion:*** *The Company should provide for the entire amount of loss of Rs. 2,00,000 arising out of insolvency of the Debtor. The fact that the Company has already made a general provision for bad debts at 5% of its total debtors is* ***irrelevant*** *in this context.*

Note: *On the other hand, if the loss due to earthquake had occurred in April, the above treatment would not be proper since it does not relate to conditions existing at the Balance Sheet Date*

QUESTION 10

Shikhivahan Ltd wants to adjust the bank balance on the Balance Sheet Date by reversing the entry for a cheque issued in the normal course of business and cancelled after the year-end but before the finalisation of accounts. The cheque was returned on the ground that the signature differs. Give your views on the above.

*Since the matter relating to difference in signature **existed** on the Balance Sheet Due (though known afterwards), the reversal of the entry can be made as on the Balance Sheet Date if the amount is material.*

QUESTION 11

A Limited Company closes its accounts on 31st March every year. It issued a cheque in favour of one of its customers towards the refund of advance in January. In June, the customer returned the cheque to the Company without presentation to the Bank while accounts of the Company for that year were being finalized. Since the cheque was cancelled, the reversal entry was passed in the books of account as on 31st March with a view to disclose the correct balance as on that date, instead of showing the Bank Balance lower by treating the cheque as "issued but not encashed as on 31st March". Whether the reversal entry passed in the books of account of the Company as on 31st March was proper since the cheque was cancelled before closing of the accounts for the year?

1. The event of cancellation of cheque after the B/s date did not relate to conditions existing at the Balance Sheet date.

*2. **Conclusion:** Bank Balance as on Balance Sheet date should not be adjusted by passing a reversal entry since it is not an "Adjusting Event". However, if the amount of the cheque is material enough to affect the financial position of the Company, its disclosure should be made in the report of the approving authority, i.e. Board of Directors.*

QUESTION 12

A Company follows April to March as its Financial Year. The Company recognizes cheques dated 31st March or before, received from customers after B/s date, but before approval of Financial Statements by debiting Cheques in Hand A/c and crediting Debtors A/c. The cheques-in-hand is shown in the Balance Sheet as an item of Cash and Cash Equivalents. All cheques in hand are presented to Bank in the month of April and are also realized in the same month in normal course after deposit in the Bank. State with reasons, whether the collection of cheques bearing date 31st March or before, but received after B/s date is an Adjusting Event, and how this fact is to be disclosed by the Company?

1. Cheques are received only in the month of April, i.e. after the B/s date. Therefore, such receipts are a transaction taking place only in the subsequent financial year, and should be recorded only in the next Financial Statements.

2. These are neither Adjusting Events nor Non-Adjusting Events.

3. Such cheques are not in hand on the date of Balance Sheet date, and hence should not be shown as Cash & Cash Equivalents in the Balance Sheet date.

*13. You are an accountant preparing accounts of Azhaga Ltd as at 31st March. After the end of the year, the following events took place in April. [F (A/c) - **RTP] P** (A/c) - **RTP,** M 03, M 16]*

• A fire broke out in the premises, damaging uninsured stock worth Rs. 10 Lakhs (Salvage Value Rs. 2 Lakhs).

« A suit against the Company's advertisement was filed by a party claiming damage of Rs. 20 Lakhs.

• Dividend proposed at 20% on Share Capital of Rs. 100 Lakhs.

Describe, how the above will be dealt with in the accounts for the year ended 31st March.

*1. **Loss due to fire:** AS-4 requires disclosure of those events occurring after the Balance Sheet date that represent material changes and commitments affecting the financial position of the enterprise, in the report of the approving authority. In the given case, the fire and consequent Stock Loss did not pertain to conditions that existed at the Balance Sheet date. Therefore, it is sufficient if the fire incident and loss thereof is **disclosed** in the Directors' Report.*

*2. **Suit against the Company:** Suit filed against the Company being a Contingent Liability must be disclosed alongwith the nature of contingency, an estimate of the financial effect and uncertainties which may affect the future outcome, in accordance with **AS - 29.***

*3. **Proposed Dividend:** See question below.*

QUESTION 13

The Management states that Proposed Dividend does not represent a liability and therefore, no provision need be made. As an Auditor, give your views.

"Non-Provision of Proposed Dividend goes against the prescribed form of Balance Sheet under Schedule III". Comment.

AS-4 prescribes that adjustments to Assets and Liabilities are required for events occurring after the Balance Sheet date that provide additional information materially affecting the determination of the amount relating to conditions existing at the Balance Sheet date, generally called Adjusting Events. "Proposed Dividend" is shown and adjusted in the Balance Sheet even if it is not an Adjusting Event as per AS-4 because it is proposed by the Board of Directors of the Company after the Balance Sheet date. Keeping this in view, is it not violation of AS-4 to show Proposed Dividends as Current Liabilities and Provisions? Comment. [F (A/c) - N10]

For the year ended 31st March 2018, the Financial Statements of Skanda Pvt Ltd were adopted on 31st July 2018. At the meeting, the Directors proposed a Dividend for the year 2017-2018 of 25% on the Equity Share Capital amounting to Rs. 10 Lakhs. No entry was passed for the Proposed Dividend in the books of the Company, since in the view of the Directors the same was not required as per Schedule HI.

*1. **Schedule III:** Sch.III requires adjustment of Dividends against the balance in P&L, as and when paid. Also, Item U of Schedule III, requires Proposed Dividends to be disclosed as a **Footnote** (after the Footnote for Contingent Liabilities and Commitments). Further, wherever required, Schedule III shall stand modified, in tune to meet AS requirements.*

*2. **Analysis:** In Schedule III, Proposed Dividend should.be disclosed **separately** in the Notes to Accounts. Also, as per AS-4 If an Enterprise declares Dividends to Shareholders after the B/s date, the enterprise should not recognize those Dividends as a liability at the B/s Date.*

*3. **Conclusion:** Since Schedule III and AS specifies not to recognize Proposed Dividend as a liability, Proposed Dividend is to be disclosed appropriately in Notes to Accounts (Per Share Rate, Amount, Percentage, etc.).*

QUESTION 14

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

(i) ***A fire broke out in the premises damaging, uninsured stock worth Rs. 10 lakhs (Salvage value Rs. 2 lakhs).***

(ii) ***A suit against the company's advertisement was filed by a party claiming damage of Rs. 20 lakhs.***

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

Answer

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

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

QUESTION 15

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

Answer

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

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

QUESTION 16

A major fire has damaged the assets in a factory of a Limited Company on 5th April – five days after the year end and closure of accounts. The loss is estimated at Rs. 10 crores out of which

Rs. 7 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.

Answer

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

QUESTION 17

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

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

Answer

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

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

QUESTION 18

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

(i) Cheques collected by the marketing personnel of the company from the stockists on or before 31^{st} March, 2013.

(ii) Cheques sent by the stockists through courier on or before 31st March, 2013.

Answer

(i) Cheques collected by the marketing personnel of the company is an adjusting event as the marketing personnels are employees of the company and therefore, are representatives of the company. Handing over of cheques by the stockist to the marketing employees discharges the liability of the stockist. Therefore, cheques collected by the marketing personnel of the company on or before 31^{st} March, 2013 require adjustment from the stockists' accounts i.e. from 'Trade Receivables A/c' even though these cheques (dated on or before 31^{st} March, 2013) are presented in the bank in the month of April, 2013 in the normal course. Hence, collection of cheques by the marketing personnel is an adjusting event as per AS 4 'Contingencies and Events Occurring after the Balance Sheet Date'. Such 'cheques in hand' will be shown in the Balance Sheet as 'Cash and Cash equivalents' with a disclosure in the Notes to accounts about the accounting policy followed by the company for such cheques.

(ii) Even if the cheques bear the date 31^{st} March or before and are sent by the stockists through courier

on or before 31st March, 2013, it is presumed that the cheques will be received after 31st March. Collection of cheques after 31st March, 2013 does not represent any condition existing on the balance sheet date i.e. 31st March. Thus, the collection of cheques after balance sheet date is not an adjusting event. Cheques that are received after the balance sheet date should be accounted for in the period in which they are received even though the

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

QUESTION 19

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

(i) ***An agreement to sell a land for Rs. 30 lakh to another company was entered into on 1st March, 2013. The value of land is shown at Rs. 20 lakh in the Balance Sheet as on 31st March, 2012. However, the Sale Deed was registered on15th April, 2013.***

(ii) ***The negotiation with another company for acquisition of its business was started on 2nd February, 2013. Pradeep Ltd. invested Rs. 40 lakh on 12th April, 2013.***

Answer

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

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

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

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

QUESTION 20

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

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

Answer

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

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

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

AS-5: NET PROFIT OR LOSS FOR THE PRIOD, PRIOR PERIOD ITEMS & CHANGES IN ACCOUNTING POLICIES

CA. TEJAS SUCHAK

NET PROFIT OR LOSS FOR THE PERIOD

Net Profit or Loss for the period includes the following components

1. Profit or Loss from ***ordinary activities***; and
2. ***Extraordinary items***.

Both these components should be disclosed on the face of statement of profit and loss.

EXTRAORDINARY ACTIVITIES

Extraordinary activities are items of incomes or expenses that arise from events or transactions that are

- clearly distinct from the ordinary activities of the enterprise,
- Not expected to recur frequently or regularly.
- Nature & Amount of extraordinary activities should be separately disclosed in the statement of profit and loss.
  - Such disclosure should be made in a manner that its effect on current profit or loss can be perceived.

Examples of extraordinary activities:

- Govt. grant becomes refundable.
- Loss due to earthquake.
- Attachment of property.
- Government grant with no related costs.

ORDINARY ACTIVITIES

Ordinary activities are activities that are

- Undertaken by the enterprise as part of its business.
- Related activities in which the enterprise engages in
  - furtherance of,
  - incidental to, or
  - arising from

  these activities.
- It also includes activities of ***exceptional nature***.

ORDINARY ACTIVITIES OF EXCEPTIONAL NATURE

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

Examples:

- Write down of invent. to NRV.
- Reversal of the above writedowns.
- P&L from disposal of fixed assets.
- P&L from disposal of L.T.Invest.
- Legislative changes.
- Litigation settlements.

PRIOR PERIOD ITEMS

- Incomes or expenses which arise in the current period
- as a result of ***errors or omissions*** in preparation of F.S. of one or more prior periods.
- Nature & amount should be separately disclosed.

ERRORS OR OMMISSIONS

Errors or omissions may arise as a result of:

- Mathematical mistakes.
- Mistakes in application of accounting policies.
- Misinterpretation of facts.
- Oversight.

AS-5: NET PROFIT OR LOSS FOR THE PRIOD, PRIOR PERIOD ITEMS & CHANGES IN ACCOUNTING POLICIES

CA. TEJAS SUCHAK

CHANGE IN ACCOUNTING POLICIES

A change in accounting policy should be made only if:

- Such change is required by the statute.
- For compliance with an AS.
- It leads to more appropriate presentation of the F.S.

Following are not considered to be change in accounting policies:

- When an accounting policy is adopted for events or transactions that

- differ significantly in substance from earlier events or transactions.
- Did not occur earlier
- Were earlier immaterial.

EFFECT OF CHANGE IN ACCOUNTING POLICIES

- Effect (i.e. impact & its resulting adjustments) should be shown in the F.S. of the period in which change is made.
- If effect is not ascertainable such fact should be disclosed.
- If such change is not expected to have a material effect in the current period but it will have a material effect in later periods, the fact of such change should be disclosed in the period in which the change will have effect.

CHANGE IN ACCOUNTING ESTIMATE

An estimate may have to be revised if:

- There is a change in the circumstances on the basis of which such estimate is made.
- The enterprise now possesses new information, more experience.
- There have been subsequent developments after the initial estimate was made.

NOTE: Such a revision is not treated as an extraordinary item or a prior period item.
NOTE: If sometimes it is difficult to distinguish between a change in accounting policy or a change in accounting estimate, the entire change should be treated as a change in accounting estimate.

EFFECT OF CHANGE IN ACCOUNTING ESTIMATE

Effect of change in accounting estimate should be disclosed in

- The period of change, if it affects current period only.
- The period of change & the future periods, if it affects both.

AS-5: PROFIT & LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS & CHANGES IN ACCOUNTING POLICIES

CA TEJAS SUCHAK
ACCOUNTANCY ACE

QUESTION 1

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

Decide whether a separate disclosure of arrear wages is required.

Answer

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

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

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

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

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

QUESTION 2

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

In March, 2012, the claim was passed and the company received a payment of

Rs. 3,50,000 against the claim. Explain the treatment of such receipt in final accounts for the year ended 31st March, 2012.

Answer

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

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

QUESTION 3

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

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

Answer

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

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

QUESTION 4

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

Answer

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

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

	Rs.
Closing Stock (including damaged goods)	*1,50,000*
Less: Revised value of damaged goods Closing stock (excluding damaged	*(4,000)*
goods)	*1,46,000*

QUESTION 5

Define extraordinary items and how it should be disclosed as per Accounting Standard-5?

OR

Write a short note on extraordinary items

Ans. *Extraordinary Items are income expenses that comes from event or transaction that are clearly distinct from ordinary act and, therefore, are not expected to recur frequently or regularly.*

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

Virtually all items of income and expenses included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

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

QUESTION 6

When can an item qualify to be a prior period item?

OR

Write shot notes on prior period items.

OR

Define prior period items and its discloser requirements as per Accounting Standard-5.

OR

"Change in accounting estimates is neither prior period items nor extra ordinary items." Comment.

Ans. Prior Period items *are income or expenses, which arise, in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods*

Discloser Requirements*: The nature and amount of prior period items should be separately disclosed in the profit and loss account in a manner that their impact on the current or loss can be perceived.*

The Term 'prior period items' refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

Errors in the preparation of the financial statements of one of more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

Prior period items are genially infrequent in nature and can be distinguished from changes in accouting estimates. Accounting estimates by their nature are approximations that my need revision, as additional information becomes known, e.g., income or expense recognized on the outcome of a contingency, which previously could not be estimated reliably, does not constitute a prior period item.

Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach to show such items in the profit and loss account after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

QUESTION 7

When a change in accounting policy can be made? What are the discloser requirements in this regard? Write a short note on change in accounting policy.

Ans. Accounting policies *are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.*

Changes in Accounting Policies: *A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.*
The following are not changes in accounting policies:

Adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer *in place of ad hoc ex-gratia payments to employees on retirement; and Adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial*

A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by this Statement should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard.

QUESTION 8

Insurance claim of Rs.2 lakhs received stands included under miscellaneous income.

Ans. Amount received on account of Insurance claim: *The principles laid down in AS-5 that even those items of income and expenses which are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance maybe disclosed separately. However, money received from the insurance company is against a specific loss. It has to be adjusted against the loss. The auditor should check the adjustment of the amount received in short of the value of actual loss as per the insurance policy. In respect of claim against an asset, the profit and loss account should be debited with the shortfall of the claim against the book value, if book claim was lodged in the previous year but no entries were passed. Entries in the profit and loss account should be appropriately described.*

QUESTION 9

A sum of Rs.10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing Rs.8,00,000. The amount is credited to the Purchases Account State briefly the duty of an auditor with regard to above.

Ans. *Amount Received from an Insurance Company: AS-5 requires that all items of income and expense which are recognized in a period should be included in the determination of net profit or loss for the period. The claim for loss of goods in transit is arising out of ordinary activities of the enterprise as a part of its normal course of business. However, the cost of goods lost in transit is only Rs.8,00,000 while the insurance money received is Rs.10,00,000. Purchase account need not be credited since it would distort the purchase done during the year and as also the gross profit. Therefore, entries amount of Rs.10 lacs need to be taken to profit and loss account under an appropriate head. This is an income arising from ordinary activities for the enterprise but having regard to amount involved and exceptional nature, a separate disclosure be made in the profit and loss account. Such disclosure would enable the users to understand the performance of an enterprise for the period.*

QUESTION 10

A loss of Rs.2,00,000 on account of embezzlement of cash was suffered by the company and it was debited to Salary Account. State briefly the duty of an auditor with regard to above.

Ans. Embezzlement of Cash: *AS-5 requires that "all items of income and expense which are recognized in a period should be included in the determination of net profit or loss for the period". It further states "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately" Embezzlement of cash during the course of business is a 'business loss', it is business hazard, which can occur once in a while. It cannot be merged under a distinct head in the profit and loss account.*

QUESTION 11

A limited company estimated 1% bad debt while preparing financial statement of for the year ended 31.12.98. Provision for doubtful debts was created accordingly. However it appears in 1999 that some receivables are still lying uncollected. The management feels that an additional 40% provision is necessary on such debts. Should such change in estimate the treated as extraordinary item? Is it prior period item? Discuss briefly.

Ans. The preparation of financial statements involves making estimates which are based on the circumstances existing at the time when the financial statement is prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate does not bring the resulting amount witch in the definition either of prior period items or of an extraordinary item.

In the given case a limited company estimated 1% bad debt at the end of the accounting year 1998 and accordingly made a provision for doubtful debt. Subsequently in 1999 they revised the estimates based on the changed circumstances and want to create 40% provision. As per AS-5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.
However, as per AS-5 (Revised), a change in accounting estimate which has material effect in the current period should be disclosed.

QUESTION 12

Agro Co. Ltd about the treatment of the following statement of accounts the year ended 31st March, 1998.

The Company finds that the stock sheets as on 31st March, 1997 had included twice an item the cost of which was Rs.55,000.

Ans. *The reflector in stock value necessary to deduct Rs.55,000 from opening stock in the profit and loss on account from 31st march 1998 it is also necessary to charge Rs.55,000 as prior period adjustment in the Profit and Loss Account below the line. It may be mentioned that Para 15 of AS-5 (Revised) requires separate disclosure of Prior Period Items (which can be shown either above the line or below the line as per para 19).*

QUESTION 13

A large manufacturing company, during the financial year 1999-2000, has written down its inventories to net realizable value by Rs.7,00,000. State with reasons, whether separate disclosure is required in the accounts of the company.

Ans. *Although the case under consideration does not relate to extraordinary item, however the nature and amount of such item, however the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance, Para 12 of AS-5 [Revised in 1997) on Net Profit or Loss For the Period. Prior period items and Changes in Accounting Policies states that*
When items of income expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

QUESTION 14

Under what circumstances can an enterprises change its accounting policy?

Ans. *A Change in accounting policy is made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy result in more relevant or reliable information about the financial position, performance position, performance or cash flows of the enterprise.*

P.8. A Company signed an agreement with the employees union on 1-9-2010 for revision of wages with retrospective effect form 1-4-2009. This would cost the company an additional liability of Rs.10 lakhs per annum. Is a disclosure necessary for the amount paid in 2010-11.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

APPLICABILITY

- This AS is applicable only for contractors.
- In the books of contractee the constructed asset should be recognised as perAS-10, AS-2, AS-13.

CONSTRUCTION CONTRACT:-

Is a contract with the following characteristics:-
-Is a contract for construction of an asset or combination of assets
- and includes;
  - Contracts for rendering of services that are directly related to construction contracts. Eg; Architects, project managers.
  -Contracts for destruction or restoration of assets and the restoration of environment following the demolition of assets.

SEGMENTING OF CONTRACTS

A contract for construction of number of assets should be segmented if;
-Separate proposal for each asset.
- Contractor & customer can accept or reject each part of the contract relating to a particular asset.
- Cost & Revenues of each asset can be separately identified.

COMBINING OF CONTRACTS

Contracts whether with a single customer or with several customers, should be treated as a single construction contract if;
-Multiple contracts are negotiated as a single package.
-The contracts are so closely interrelated that they in effect part of a single project with an overall profit margin.
-The contracts are performed in a continuous sequence.

CONSTRUCTION OF ADDITIONAL ASSETS

A contract may provide for construction of additional assets at the option of the customer. Construction of additional assets should be treated as a separate construction contract when;

Asset differs significantly in design, technology or function from the asset or assets covered by the original contract.

OR

The price of the asset is negotiated without regard to the original contract price.

TYPES OF CONSTRUCTION CONTRACTS

FIXED PRICE CONTRACT

-Contractor agrees to a fixed contract price or a fixed rate per unit of output.

COST PLUS CONTRACT

-Contractor gets reimbursed for the defined costs, plus percentage of the costs or a fixed fee and above the costs.

HYBRID CONTRACT

-Such contracts contain characteristics of both cost & hybrid contracts.
Eg; cost plus a percentage restricted by a maximum amount.

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CONTRACT REVENUE

Comprises of ;
-**Revenue initially agreed**
AND INCLUDES

CLAIMS

-An amount which the contractor seeks to collect from the customer or any third party for costs that are not included in the contract.
Eg;1. Customer caused delays.
2. Errors in specification.

RECOGNITION

a)Negotiations have reached a stage where it is probable that the customer will accept the claim.
b)Amount of claim can be reliably measured.

VARIATIONS

-Is an instruction by the customer for a change in the scope of contract work.
-May lead to increase or decrease in contract revenue.
Eg;1. Changes in specification in design.
2. Changes in duration of work.

RECOGNITION

a)probable that the customer will approve variation
b)Amount of variation can be reliably measured.

INCENTIVE PAYMENTS

-Payments made to the contractor by the customer if specified performance standards are met or exceeded.
Eg;1. Early completion of the contract work.

RECOGNITION

Should be recognised only when;
a)Contract is sufficiently advanced that it is probable that such payments will be realised.
b)Amount of such payments can be measured reliably.

CONTRACT COSTS

INCLUDES

DIRECTLY RELATED COSTS

Eg;1.Site labour costs
2.Material costs
3.Deprecition of P&M
4.Cartage, conveyance costs.

COSTS ATTRIBUTIBLE TO CONSTRUCTION ACTIVITY

1.Overheads

2.Costs of design & technical assistance not related to a specific project.

SPECIFICALLY CHARGEABLE TO A CUSTOMER

May include general administration & development costs for which reimbursement is specified in the contract.

COST OF SECURING THE CONTRACT

Costs that directly relate to securing the contract are treated costs; Provided they can be separately identified and measured reliably & it is probable that the contract can be obtained.

EXCLUDES

-General administration for which reimbursement is not specified.
-Selling costs
-Research & Development costs for which reimbursement is not specified in the contract.
-Depreciation of idle P&M not used in the construction contract.

REVENUE RECOGNITION

Whether outcome the contract can be measured reliably

Y → Recognise revenue and costs in proportion to the work completed. i.e. proportionate profits will be recognised.

N → Revenue (if realisable) will be recognised only to the extent of costs incurred i.e. no profits can be recognised.

When it is probable that estimated total contract costs exceeds the contract revenue, full loss will be recognised in the P&L irrespective of;

1. Whether or not work has commenced on the contract.
2. The stage of completion of contract activity.
3. The amount of profits expected to arise on other contracts which are not treated as a single construction contract.

DETERMINATION OF STAGE OF COMPLETION

1. Proportion of contract costs incurred for work performed upto the reporting date to the total contract costs.

   $$= \frac{\text{Contract Costs incurred}}{\text{Total contract costs}}$$

   - Exclusions from contract costs incurred:-
     - Contract costs paid for future activities.
     - Payments to subcontractors in advance.
2. Surveys of work performed.
3. Completion of physical proportion of contract work.

DISCLOSURES

- Amount of contract revenue recognised in the period
- Method used to determine contract revenue
- Method used to determine stage of completion of contracts.

In respect of contracts in progress:

- The amount of costs incurred and recognised profits upto the reporting date.
- Amount of advances received.
- Amount of retentions.

Also disclose

- The amount due from customer for contract work as an asset.
- The amount due to customer for contract work as a liabilitv.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

Question 1

A Public Sector Company undertakes as a part of its activities, construction of properties and sells the same. The Company recognizes profits on Percentage of Completion Method which is further reduced to 80% for keeping an appropriate allowance for future unforeseeable factors in Cost and Sale prices till the project is fully completed.

One of the Projects of the Company has two different sites. While one site was sold and part payment received, the other site was yet to be allotted / sold to any party. However, for the purpose of booking estimated profit, it was felt that the profit on unsold site should also be booked. So, the Sale Price for unsold site was also worked out on the basis of the price at which another site was sold and the Total Profit was calculated with reference to the Total Sale Price of both the sites and the Total Estimated Expenditure of all the sites which was further limited by applying Percentage of Completion worked out as stated above and the profit so calculated was further reduced to 80% as per the accounting policy and the result was included in the P & L a/c as Notional Profit. Discuss whether the A/c treatment is correct.

*1. **AS - 7:** AS - 7 should be applied in accounting for Construction Contracts in the Financial Statements of "Contractors". In the above case, the Company is engaged in Construction and Sale of properties on its own account and not as Contractors. As the Company operates on its own account as a venture of a commercial nature by entering into agreements for sale, AS - 7 will **not be applicable.***

*2. **AS - 9:** The Recognition of Revenues from Sale activity is governed by AS - 9. Under AS - 9, revenue from sales should be recognised only upon compliance with the conditions therein, viz. - (a) Transfer of Property and risks thereof to the Buyer, (b) No control of Seller over goods, (c) Certainty of amount involved, and (d) Certainty of collection.*

*3. **Analysis:***

(a) The first site was actually sold, and hence Revenue Recognition is proper if other conditions of AS - 9 are satisfied.

(b) The second site was not sold / booked by any party. Hence, there is no basic reason for Revenue Recognition and this constitutes the Closing Stock / Work-in-Progress of the Company.

*4. **Conclusion:** Revenue Recognition for the second site is not in accordance with AS - 9. The practice of applying Percentage of Completion, or 80% factor, etc. is irrelevant in respect of the second site.*

Question 2

Bharati Ltd is engaged in the business of developing mass scale housing projects including development of small commercial complexes. The Flats / Commercial Spaces are booked by the public and are allotted by way of Allotment Letter to each Allottee. Major construction activities pertaining to Buildings are undertaken after allotment is over. After completing the construction, possession of Flats / Commercial Spaces is given to Allottees by executing legal document. The CEO of the Bharati says that AS-7 is not applicable to the Company. Decide.

***Conclusion:** Company is **not a Contractor,** but operating only on **"own account"** basis. Hence, **AS - 7 is not applicable.** However, AS-9 and AS-2 will be applicable.*

Question 3

Sambu Ltd negotiates with Indian Oil, for construction of "Franchise Retail Petrol Outlet Stations". Based on proposals submitted to different Zonal Offices of Indian Oil, the final approval for one outlet each in Berhampore, Salem, Vadodara and Warrangal is awarded to Sambu Ltd. Agreement (in single document) is entered into with Indian Oil for Rs. 25 Lakhs. The agreement lays down values for each of the four outlets (Rs. 44 + 66 + 80 + 55 Lakhs) in addition

to individual completion time. Comment whether Sambu Ltd will treat it as a single contract or four separate contracts.

• ***Analysis:*** *Here, each Outlet is submitted as a separate proposal to different Zonal Office, separately negotiated, and costs and revenues thereof can be separately identified. Hence, each Asset will be treated as a* ***"single contract"*** *even if there is only one document of contract.*

• ***Conclusion:*** *Four separate Contract Accounts have to be recorded and maintained in the books of Sambu Ltd. For each contract, principles of revenue and cost recognition have to be applied separately, and Net Income determined for each asset as per AS-7.*

Question 4

Nandi, a Contractor, has just entered into a contract with a Local Municipal Body for building a Flyover. As per the contract terms, Nandi will receive an additional Rs. 2 Crores, if the construction of the Flyover were to be finished within a period of two years of the commencement of the contract. Nandi wants to recognize this revenue since in the past he has been able to meet similar targets very easily. Give your views on the above.

1. ***Analysis:*** *Incentive Payments are included in Contract Revenue when the contract is sufficiently advanced that it is probable that the specified performance standards will be met and the amount of the incentive payment can be measured reliably.*

2. ***Conclusion:*** *In the above case, the contract is not even begun. The Contractor should not recognize Incentive Income.*

Question 5

Contractors Ltd have recognized Contract Revenue on a contract awarded in the current financial year. The target date of completion is 5 years. The Contract provides for Incentives for early completion at the rate of Rs. 1,000 per day, subject to a maximum of Rs. 3,00,000. The Company has included this amount in the Contract Revenue (in the first year of contract) on the ground that based on the previous experience in similar contract, it is confident of completing the contract in 4 years. The Company's past track record shows that the Company was able to complete such contacts well in time and earn incentives. Comment on the Company's accounting policy.

1. Past Track Record is ***not*** *a criteria for recognition of Incentive Payments Receivable for early completion of contract.*

2. In the above case, the contract is not sufficiently advanced, i.e. first year only and its normal time of completion in 4 — 5 years. Hence, the recognition criteria of Incentive Payments as per AS-7 are not satisfied. Inclusion of Incentive Payments Receivable in the current year as part of Contract Revenue is not proper.

Question 6

Viswakarma Ltd undertook a Construction Contract for Rs. 50 Crores in April. The cost of construction was initially estimated at Rs. 35 Crores. The contract is to be completed in 3 Years. While executing the contract, the Company estimated the cost of completion of the contract at Rs. 53 Crores. Can the Company provide for the expected loss in the books of accounts for the year ended 31st March?

1. Provision: *As per AS-7, an Expected Loss on Construction Contract should be recognized as an* ***Expense*** *immediately.*

2. ***Conclusion:*** *The Loss of Rs. 3 Crores (53 Crores - 50 Crores) should be recognised immediately by Viswakarma Ltd in the current Financial Year.*

Question 7

Mayan Construction Company accounted for a Contract entered into with a Government Department on Completed Contract Method and that with a Private Sector Company on Percentage of Completion Method. Both the Contracts were for development of a Township. State your views on the above.

*1. **Principles:** Revenue & Costs associated with a Construction Contract should be recognized as revenue and expenses respectively by reference to the stage of completion of the Contract activity at the reporting date.*

*2. **Analysis:** In the given case, the Construction Company accounts for the Contract with Government Department on Completed Contract Method and for the Contract with Private Sector Company, on Percentage Completion Method.*

*3. **Conclusion:** In view of the requirements of AS - 7, the Contractor should use **only** Percentage of Completion Method for recognizing revenue and expenditure of both the Construction Contracts. So, use of Completed Contract Method for the Contract with Government Department is not correct.*

Question 8

Compute the percentage of completion and the Contract Revenues and Costs to be recognised from the following data.

• Contract Price - Rs. 75 Lakhs

• Materials issued - Rs. 18 Lakhs of which Materials costing Rs. 3 Lakhs is still lying unused at the end of the period.

• Labour paid for workers engaged at site - Rs. 12 Lakhs (Rs. 2 Lakhs is still payable)

• Specific Contract Costs - Rs. 6 Lakhs, Sub-Contract Costs for work executed - Rs. 5 Lakhs, Advances paid to subcontractors - Rs. 3 Lakhs

• Cost estimated to be incurred to complete the Contract - Rs. 30 Lakhs

Here, the Proportionate Cost Method will provide a realistic estimate of stage of completion. This is calculated as under -

	Particulars	***Computation***	***Amount***
	Materials Cost incurred on the Contract (net of Closing Stock)	*Rs. 18 (-) Rs. 3*	*15 Lakhs*
Add:	*Labour Costs incurred on the Contract (paid + payable)*	*Rs. 12 + Rs. 2*	*14 Lakhs*
	Specific Contract Costs	*Given*	*6 Lakhs*
	Sub-Contract Costs (advances should not be considered)	*Given*	*5 Lakhs*
	Costs Incurred Till Date		*40 Lakhs*
Add:	*Further Costs to be incurred*	*Given*	*30 Lakhs*
	Total Contract Costs		*70 Lakhs*
	Hence, Percentage of Completion based on Costs = $\frac{\text{Cost incurred till date}}{\text{Estimated Total Costs}}$	$\frac{40}{70}$	*57.14%*

	Contract Revenue to be recognised (as per Para 21)	*57.14% × Rs. 75*	*42.86 Lakhs*
Less:	*Contract Costs to be recognised (as per Para 21)*	*as computed*	*40.00 Lakhs*
	Therefore, Contract Profit		***2.86 Lakhs***

Question 9

A Company took a Construction Contract for Rs. 100 Lakhs in January. It was found that 80% of the Contract was completed at a cost of Rs. 92 Lakhs on the closing date i.e. 31st March. The Company estimates further expenditure of Rs. 23 Lakhs for completing the Contract. The Expected Loss would be Rs. 15 Lakhs. Can the Company recognise the loss in the Financial Statements prepared for the year ended 31st March?

Solution: *The Company should recognise Rs. 15 Lakhs as an Expense immediately.*

Question 10

Certain Ltd has signed at 31st Dec, the Balance Sheet date, a contract where the Total Revenue is estimated at Rs. 15 Crores and Total Cost is estimated at Rs. 20 Crores. No work began on the contract. Is the Contractor required to give any accounting effect for the year ended 31st December?

Solution: *There is an Expected Loss of Rs. 5 Crores (20 Crores - 15 Crores). Such loss should be recognized in the Profit and Loss Statement as per AS-7, even though work has not commenced.*

Question 11

A Contractor entered into a contract for building roads for Rs. 2 Crores. After completing 60% of the contract he came to know that the cost of completing the contract would be Rs. 2.40 Crores. The Accountant transferred Rs. 0.24 Crores, i.e. 60% of total Loss of Rs. 0.40 Crores to P&L Account in the current year. Give your views on the above.

The Company should recognise Rs. 0.4 Crores as an Expense immediately, irrespective of the percentage of completion.

Question 12

An amount of Rs. 9,90,000 was incurred on a contract work upto 31st March. Certificates have been received to date to the value of Rs. 12,00,000 against which Rs. 10,80,000 has been received in cash. The cost of work done but not certified amounted to Rs. 22,500. It is estimated that by spending an additional amount of Rs. 60,000 (including Provision for Contingencies) the work can be completed in all respects in another two months. The agreed Contract Price of the work is Rs. 12,50,000. Compute a conservative estimate of the profit to be taken to the P&L A/c as per AS - 7.

Particulars	***Rs.***
Total Cost *= Cost incurred till Date + Estimated Additional Cost = 9,90,000 + 60,000*	***10,50,000***
% of completion based on Cost $= \frac{Cost\ incurred\ till\ date}{Estimated\ Total\ Costs} = \frac{9{,}90{,}000}{10{,}50{,}000}$	*94.29%*
Contract Revenue to be recognised (12,50,000 x 94.29%)	*11,78,625*

Less: *Contract Cost incurred till date*	*9,90,000*
Contract Profit	***1,88,625***

Question 13

A Company undertakes a number of Contracts. Following particulars are extracted in respect of certain loss-making Contracts. Determine the amount of Expected Loss that should be recognised in the accounts for the year, (in Rs. Lakhs)

Contract	***A***	***B***	***C***	***D***
Contract Price	***15.00***	***12.50***	***87.50***	***10.00***
Cost Incurred till date	***12.00***	***10.90***	***2.50***	***6.00***
Costs expected to be incurred to complete the Contract	***4.00***	***3.60***	***88.00***	***4.00***

Computation of Expected Loss (Rs. in Lakhs)

Contract	***A***	***B***	***C***	***D***
1. Contract Price (given)	*15.00*	*12.50*	*87.50*	*10.00*
2. Cost incurred till date (given)	*12.00*	*10.90*	*2.50*	*6.00*
3. Further Costs to be incurred to complete the Contract	*4.00*	*3.60*	*88.00*	*4.00*
4. Total Contract Costs (2) + (3)	*16.00*	*14.50*	*90.50*	*10.00*
5. Expected Loss on Contract (1) - (4)	*1.00*	*2.00*	*3.00*	*Nil*
6. Percentage of Completion based on Costs = $\frac{\text{Cost incurred till date}}{\text{Estimated Total Costs}}$	*75%*	*75.17%*	*2.76%*	*60%*
7. Contract Revenue recognised (1) × (6)	*11.25*	*9.40*	*2.42*	*6.00*
8. Contract Costs recognised (as per 2)	*12.00*	*10.90*	*2.50*	*6.00*
9. Contract Profit / (Loss) (7) - (8)	*(0.75)*	*(1.50)*	*(0.08)*	*Nil*
10. Expected Loss to be recognised (as per 5)	*1.00*	*2.00*	*3.00*	*.Nil*
11. Additional Provision required (9) - (10)	*0.25*	*0.50*	*2.92*	*Nil*

Question 14

On 31st October 2017, Bharat Construction Co. Ltd. undertook a Contract to construct a Flyover for Rs. 215 Crores. On 31st March 2018, the Company found that the Work is Certified for Rs. 100 Crores and Work to be Certified is for Rs. 35 Crores. Prudent estimates of additional Cost for Completion was Rs. 90 Crores. What amount should be charged to Revenue in the Financial Accounts for the year ended 31st March 2018 as per AS -7?

Particulars	***Rs. in Crores***
1. Contract Price (given)	*215.00*
2. Cost incurred till date (Work Certified + Work to be Certified)	*135.00*
3. Further Costs to be incurred to complete the Contract	*90.00*
4. Total Contract Costs (2) + (3)	*225.00*
5. Expected Loss on Contract (1) - (4)	*(10.00)*
6. Percentage of Completion based on Costs = $\frac{Cost\ incurred\ till\ date}{Estimated\ Total\ Costs}$	*60%*
7. Contract Revenue recognised (1) × (6)	*129.00*
8. Contract Costs recognised (as per 2)	*135.00*
9. Contract Profit / (Loss) (7) - (8)	*(6.00)*
10. Expected Loss to be recognised (as per 5)	***10.00***
11. Additional Provision required (9) - (10)	*4.00*

AS-9: REVENUE RECOGNITION

CA TEJAS SUCHAK
ACCOUNTANCY ACE

DEFINITION: REVENUE

Revenue is the

- Gross Inflow of cash, receivables & other consideration
- Arising in the course of ordinary activities of an enterprise
- From:-
  - sale of goods,
  - rendering of services, and
  - use by others of enterprise resources yielding interest, royalties & dividends.

GROSS INFLOW

- Gross inflow of an enterprise will be considered as its revenue.
- Savings (net inflow) will not be considered as revenue of an enterprise.

EXCEPTION: in an agency relationship, amount of commission & not the gross inflow will be considered as its revenue.

Eg: Gains realised from an obligation discharged at less than its carrying value: there is no gross inflow, only saving in outflow hence not revenue.

CASH, RECEIVABLES & OTHER CONSIDERATION

- Cash implies that revenue can arise out of cash transactions.
- Receivables implies that revenue can arise out of credit transactions.
- Consideration implies that revenue arises only from a contract with a third party i.e. revenue cannot arise within an enterprise.

Eg: Appreciation in the value of Fixed/Current Assets will not be considered as consideration.

SALE OF GOODS

- Transfer of property in goods for a price.
- Whole or part consideration should be in money, as AS-9 does not deal with revenue recognition of barters.

Eg: Sale of Investments, Fixed Assets are not sale of goods.

ORDINARY ACTIVITIES

- Activities which are undertaken as a part of normal business &
- includes related activities which are carried in furtherance of,
  - or are incidental to
  - or arise from such ordinary activity.

REVENUE RECOGNITION FROM SALE OF GOODS

PERFORMANCE: -The seller has transferred to the buyer all significant risks & rewards of ownership,
-The seller retains no effective control of the goods to a degree usually associated with ownership.
Eg: If the seller takes Bill of Lading (document of title to goods) in his name rather than in the name of the customer, it may show that he retains effective control of goods associated with ownership.

MEASURABILITY:-There is no significant uncertainty regarding the amount of consideration that is to be derived from the sale of goods.

COLLECTIBILITY:-At the time of performance it is not unreasonable to expect ultimate collection.

AS-9: REVENUE RECOGNITION

CA TEJAS SUCHAK
ACCOUNTANCY ACE

BILL AND HOLD SALES

(Delivery is delayed at buyers' request)

Even though delivery has not been made revenue will be recognised if;

- Item is on hand, identifiable & ready for delivery to the buyer at the time sale is recognised.
- There is every expectation that delivery will be made.
- Delivery is delayed at buyer's request.
- Buyer takes title & accepts billing.

GOODS SOLD SUBJECT TO INSTALLATION

Defer revenue until the customer accepts delivery and installation & inspection are complete.

INSTALLATION PROCESSS IS SIMPLE :- Revenue may be recognised notwithstanding the fact that installation is yet to be completed. Eg: T.V.

GUARANTEED SALES

- In this case goods are sold to the buyer granting him unlimited right of return.
- Sale should be recognised as & when it takes place & a suitable provision for returns should be made based on previous experience.

SALE ON APPROVAL

Revenue should be recognised only when anyone of the following conditions are satisfied:-

1) Goods are formally accepted.
2) Buyer does an act adopting the goods.
3) Time period for rejection has elapsed.
4) Where no time is fixed, a reasonable time has elapsed.

CONSIGNMENT SALES

- Agent sells on behalf of the principal.
- Revenue is recognised only when goods are sold to a third party.

CASH ON DELIVERY SALES

-Sale should not be recognised until cash is received by the seller or his agent. (Agent includes bank, post office)

NOTE: Sale & repurchase agreements are finance transactions. Cash inflow on such transactions are recognised as a liability and not as revenue.

INSTALMENT PAYMENTS

-When purchaser makes series of instalment payments to the seller:

- Revenue is recognised when goods are delivered, or
- Based on experience, full revenue can be recognised when significant deposit is recognised.

INSTALMENT SALES

-When sale is made and consideration is received in instalments.

-Sale price is recognised as revenue on the date of sales.

-Interest is recognised as revenue in proportion to the unpaid amount due to the seller.

SALE TO INTERMEDIARIES

-Significant risk of ownership has passed – Recognise as Revenue.

-Significant risk has not passed – Do not recognise as revenue. (eg:- consignment sale to an agent.)

SUBSCRIPTION REVENUE

-Recognised on straight line basis.

-items delivered vary in value:- Revenue recognised on the basis of sales value.

AS-9: REVENUE RECOGNITION

CA TEJAS SUCHAK
ACCOUNTANCY ACE

SPECIAL ORDERS

-Revenue should be recognised only when such goods are manufactured, identified and ready for delivery to the buyer.
-Payment may be received in advance but revenue will not be recognised until above condition is satisfied.

REVENUE RECOGNITION FOR SERVICES

Performance is measured either under;

COMPLETED SERVICE CONTRACT METHOD

-Revenue is recognised only when the service is completed or is substantially complete.
-This method is applied when act to be performed is a single act.
Eg; Insurance agency commission.

REVENUE RECOGNITION

Recognised when:

- Rendering of services under a contract is complete or is substantially complete.

PROPORTIONATE COMPLETION METHOD

-Revenue is recognised proportionately with respect to degree of completion.
-Method is applied where a series of acts are performed.
Eg; Tuition fees.

REVENUE RECOGNITION

Recognised proportionately with the degree of completion.

PERFORMANCE

Performance is said to be achieved when no significant uncertainty exists as to;

- The amount of consideration.
- Collectability of the amount.

INTEREST, ROYALTY & DIVIDEND

Revenue should be recognised when no significant uncertainity exists as to;

- Its measurability.
- Its collectability.

BASIS OF RECOGNITION

INTEREST	ROYALTY	DIVIDEND
TIME PROPORTION BASIS	ACCRUAL BASIS	RIGHT TO RECEIVE IS ESTABLISHED

NOTE: When interest, dividend & royalties from other countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition needs to be postponed.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

Question 1

LM Ltd has 2 divisions L and M. The finished products of the Division L are transferred to M where further processing isCcarried out before sale to customers. To achieve transparency and accountability between the divisions, Division L raises an invoice on Division M at cost plus normal margins. At the year end, the unrealized profits on inter division stocks are eliminated. However, the transfers are recorded at the Invoice Value as Sales and Purchases in the respective divisions for the purpose of preparing Profit & Loss Account. Suitable disclosures for this are given in the Notes to Accounts. Comment on the validity of the accounting treatment.

*1. **Revenue:** As per AS - 9, "Revenue is the gross inflow of cash, receivables or other consideration arising in the course of ordinary activities of an enterprise from the sale of goods, from rendering of services, and from the use by **others** of enterprise resources yielding interest, royalties and dividends". Revenue is measured by the charges made to **customers or clients** for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.*

*2. **Enterprise:** The use of the word **"enterprise"** in the above definition clearly implies that the transfers **within** the enterprise cannot be considered as "Revenue". Thus, the recognition of inter-divisional transfers as sales is an **inappropriate** accounting treatment, and inconsistent with AS - 9.*

*3. **Internal Transfers:** In case of inter-divisional transfers, risks and rewards remain with the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also **not fulfilled** in respect of inter-divisional transfers.*

*4. **Conclusion:** In the given case, LM Ltd **cannot recognise** the inter-division transfers from L to M as Sales and the same will have be eliminated during finalization. If not, the Statutory Auditor should qualify his report.*

Question 2

Hara Ltd sells agricultural products to its dealers. One of the conditions of sale is that interest is payable at 2% p.m. for delayed payment. Percentage of interest recovered is only 10% on such overdue outstanding due to various reasons. During the financial year, Hara Ltd wants to recognise the entire interest receivable. Do you agree? [F (A/c) - M 03]

Umang Ltd sold goods through its Agent. As per terms of Sales, consideration is payable within one month. In the event of delay in payment, Interest is chargeable at 12% p.a. from the Agent. The Company has not realized interest from the Agent in the past. For the year ended 31st March, Interest due from the Agent (because of delay in payment) amounts to Rs. 1,72,000. The Accountant of Umang Ltd booked Rs. 1,72,000 as Interest Income in the year ended 31st March. Discuss the contention of the Accountant with reference to Accounting Standard-9.

1. Analysis:

*(a) Interest is **incidental** to the sales transaction. If at the time of raising the claim of interest, it is unreasonable to expect ultimate collection, Revenue Recognition should be postponed.*

(b) Past experience of the Company shows that only 10% of the interest overdue on outstandings is actually recovered.

*2. **Conclusion:** The Company should **not** recognise the entire interest receivable. It should be recognised only on cash basis, i.e. receipt basis in the instant case.*

Question 3

Sambhu Ltd is a Company engaged in the business of construction of roads & bridges. It follows Completed Contract Method for all its projects. So, revenue is recognized only when the contract is completed or substantially completed. For the year ended 31st March, Sambhu Ltd has earned

a sum of Rs. 25 Lakhs as interest on Short Term Deposits with their Bank. These deposits are made out of the advances received from the customers towards the projects that they are executing. Sambhu Ltd, while filing their Return of Income for the year 31st March with the Tax Authority declared NIL income for that year. While calculating progress payments at the year-end, the interest of Rs. 25 Lakhs earned was considered as part of the funds received for the project. Is the treatment given by Sambhu Ltd with regard to the interest earned on Short-Term Deposit correct?

AS	***AS-7***	***AS-9***
Principle	*Contract Revenue and Contract Costs associated with a construction contract should be recognized as revenue and expenses respectively by reference to the **stage of completion** of the Contract activity at the reporting date.*	*Interest earned should be recognized as **Revenue** in the year in which it is earned. Interest earned on Short Term Deposits **cannot** be treated as Progress Payments Received for the Contracts in Progress.*
Conclusion	*The recognition of Contract Income on Completed Contract Method is **incorrect.***	*Interest earned on Short Term Deposits is **not** a revenue associated with the Contract, and therefore should be accounted for income in the year in which it is earned.*

Question 4

The Investments of Ramesh Ltd includes 5,000 Equity Shares of Rs. 100 each in Amudhan Bank Ltd. The Bank declared 20% dividend for the year ended 31st March 2017 at its General Meeting held on 30.06.2017. Ramesh Ltd finalised its accounts for the year ended 31.03. 2017 on 30.08.2017 and it includes Rs. 1,00,000 being the amount of Dividend by it from Amudhan Bank Ltd in its Other Income, subsequent to its Balance Sheet date before approval by the Board of Directors. Comment on whether the accounting treatment is correct.

*1. **Principle:** As per AS - 9, Dividend from Investments in Shares should be recognised as revenue, when the Owner's right to receive payment is established.*

*2. **Analysis:** In the given case, the right to receive dividend did not exist on the Balance Sheet Date, i.e. 31.03.2017, Ramesh Ltd should not recognise the dividend for the year ended 31.03.2017. It should be treated as Income, only during the next financial year, since the dividends were proposed and declared only during that financial year.*

*3. **Conclusion:** The treatment adopted by the Company is **not** in tune with AS - 9 requirements.*

Question 5

AQ Ltd, an Investment Company, is finalizing its account for the Financial Year ending 2017 in the month of August 2017. How will the following incomes be accounted for in the books of AQ Ltd?

(a) X Ltd has declared Interim Dividend which has not been received till 31.03.2017 but received on 25-04-2017.

(b) Y Ltd has declared dividend on 8th May 2017 for the year ending 31.03.2017, which has been approved by the Shareholders of the Company on 30th June 2017.

(c) Z Ltd, a Subsidiary of AQ Ltd, has declared dividend for the year ended 31.03.2017 on 25th May 2017 the AGM for which is to be held on September 2017.

Case 1: *Since, Interim Dividend is to be recognised when Dividend is received, AQ Ltd should recognise such Dividend in accounting year 2017-2018 and not in financial year ending 31.03.2017.*

Case 2: *In this case also, AQ Ltd should recognise the Dividend in the Financial Year 2017-2018 and not in the year ending 31.03.2017, since the right to receive dividend did not exist at the Balance Sheet date. Right to receive Dividend will arise, when the AGM will approve the Dividend.*

Case 3: *AQ Ltd will recognise the Dividend in the Financial Year 2017-2018, for the same reason mentioned in Case 2.*

Question 6

In the course of audit of Tripura Ltd, you observed that Export Incentives are not accounted on accrual basis. The Company's Management contended that these would be accounted on cash basis citing the uncertainty about its receipts as they are not admitted as due by the Customs Authorities. Comment.

1. Principles:

(a) As per AS-1, "Prudence" is one of the major considerations in selection of accounting policies, i.e. profits are not anticipated but recognized only when realized though not necessarily in cash.

(b) As per AS-9, Revenue Recognition, Revenue should be recognized only if its realization is reasonably certain.

2. ***Conclusion:*** *In the present situation, the Auditor has to consider the certainty of receipt, facts of the case, previous instances of duty claims and its results, subsequent events after the BS date on acceptance by Customs Authorities, and accordingly consider the impact on Financial Statements.*

Question 7

Isha Ltd has a total turnover of Rs. 100 Crores, which includes a sum of Rs. 18 Crores representing Royalty Receivable for supply of know-how to a Company based in Iraq. As per the agreement, the royalty amount shall be received in Iraqi Dinar. However, due to war / emergency, exchange permission has been denied to the Iraqi Company for remitting the royalty. Isha Ltd would like to recognise revenue but make a provision of 75% of the Royalty Receivable towards Bad Debts. Is this correct?

1. Principles: *Recognition of Revenue requires satisfaction of two conditions - (a)* ***measurability,*** *i.e. Revenue is* ***measurable,*** *and (b)* ***collectability,*** *i.e. at the time of sale of goods or the rendering of the service it would not be unreasonable to expect ultimate collection.*

2. ***Uncertainty:*** *When uncertainty as to collection arises at the time of claim / sale / rendering the service, revenue recognition is* ***postponed*** *to the extent of uncertainty involved. Revenue is recognised only to the extent of certainty.*

3. ***Conclusion:*** *In the above case, as there is significant uncertainty as to collectability of the amount, the Company should not recognise revenue in the current year. The question of making a provision (irrespective of percentage) does not arise, since revenue should not have been recognised in the first place.*

Question 8

Given the following information of Paper Products Ltd -

(a) Goods of Rs. 60,000 were sold on 20.03.2018 but at the request of the Buyer these were delivered on 10.04.2018.

(b) On 15.01.2018 goods of Rs. 1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31.03.2018.

(c) Rs. 1,20,000 worth of goods were sold on approval basis on 01.12.2017. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31.01.2018 and no approval or disapproval received for the remaining goods till 31.03.2018.

(d) Apart from the above, the Company has made Cash Sales of Rs. 7,80,000 (Gross). Trade Discount of 5% was allowed on the Cash Sales.

You are required to advise, with valid reasons, the amount to be recognized as Revenue in above cases under AS-9 and also determine the Total Revenue to be recognized for the year ending 31.03.2018.

Situation	***Treatment***	***Revenue recognised***
Goods Sold, delivery delayed at Buyer's request	*Revenue should be recognised notwithstanding that physical delivery has not been completed so long as .there is every expectation that delivery will be made.*	*Rs. 60,000*
Consignment Sales	*Revenue on Consignment Sales is recognised only when goods are sold* *by the agent to a third party.* ***Note:*** *Cost of Stock with Consignee should be taken into account*	*80% × Rs. 1,50,000* *= Rs. 1,20,000*
Goods sold on approval basis	*• Revenue should not be recognised until the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.* *• 3 Months period has elapsed for all goods. Hence, entire revenue should be recognised.*	*Rs.1,20,000*
Trade Discounts	*Trade Discounts and Volume Rebates received do not fall within the definition of Revenue, since they represent a reduction of cost. Hence,* *these Discounts and Volume Rebates given should be* ***deducted*** *to determine revenue.*	*7,80,000 - 5%* *= Rs. 7,41,000*
	Total	***Rs. 10,41,000***

Question 9

Vishnu Ltd purchased goods on credit from Pinaki Ltd, for Rs. 5 Crores for export purposes. Upon the export order being cancelled, Vishnu Ltd decided to sell the same in the domestic market at a discounted price. Accordingly Pinaki Ltd was requested to offer a price discount of 25%. Pinaki Ltd wants to adjust the sales figure to the extent of discount requested by Vishnu Ltd. State your views.

1. Pinaki Ltd has ***"sold"*** *goods on credit worth Rs. 5 Crores to Vishnu Ltd. Hence, the* ***sale is complete*** *in all respects. Vishnu Ltd's decision to sell the same in the domestic market at a discount does* ***not*** *affect the amount recognised as Sales Income by Pinaki Ltd.*

*2. Price discount of 25% offered by Pinaki Ltd at the request of Vishnu Ltd is **not** in the nature of discount given during the ordinary course of trade, since it would have been given at the time of sale itself.*

*3. As there appears to be an uncertainty relating to readability of the 25%, which has arisen subsequent to the time of sale, Pinaki Ltd should make a **separate provision** to reflect the uncertainty relating to collectibility, rather than to adjust the amount of revenue originally recorded.*

*4. The **Discount Allowed** should be shown as an **Expense** in the P & L A/c of Pinaki Ltd separately, and **not** shown as deduction from the Sales figure.*

Question 10

Prabhu Ltd entered into a contract with Deva Ltd to despatch goods valuing Rs. 1,00,000 every month for 6 months upon receipt of entire payment. Deva Ltd accordingly made the payment. In the 3rd month, due to a natural calamity, Deva Ltd requested Prabhu Ltd not to despatch until further notice. Prabhu Ltd accounted Rs. 2,00,000 as Sales and transferred the balance to Advance Received against Sales. Comment.

***1. Analysis:** The transfer of property in goods results in or coincides with the transfer of significant risks and rewards of ownership to the Buyer. Also, the sale price has been recovered by the Seller. Hence, the sale is complete in the given case, but delivery has been postponed at Buyer's request.*

*2. **Conclusion:***

(a) The Seller Company should recognise the entire income of Rs. 6 Lakhs as Income (Rs. 1 Lakh p.m. for 6 months) and no part of the same is to be treated as Advance Receipt against Sales.

Question 11

The Board of Directors of Himadri Ltd decided on 31st March 2018 to increase the sale price of certain items retrospectively from 1.1.2017. In view of this price revision with retrospective effect, the Company has to receive Rs. 15 Lakhs from its customers in respect of sales made from 1.1.2017 to 31.3.2018 (i.e. 15 months period) and the Accountant cannot make up his mind whether to include Rs. 15 Lakhs in the Sales for 2017-2018. Comment on the accounting treatment.

***1. Analysis:** The price revision was effected during the current accounting period. So, it is **not** a Prior Period Item as per AS - 5 as there is no error or omission in the past financial year.*

*2. **Conclusion:** As per AS - 9, if the Company is able to assess the ultimate collection with reasonable certainty, then additional revenues arising out of the said price revision may be recognised in the current financial year.*

Question 12

Pinakapani Publishing Company is engaged in publishing of books for professionals. It invoices its Distributors at List Price less 45% discount. The Distributors are also entitled to a commission of 7.5% on the List Price on the books actually sold by them. Unsold books can be returned to the Publisher at the end of the period. When should revenue be recognised by the Publishing Company?

*1. **Analysis:** Since unsold books can be returned to the Publisher at the end of the period, significant risks and rewards of ownership lie only with the Publishing Company. However, the risk of bad debts may have been transferred to the Distributor for the commission incentive earned by him.*

*2. **Basis:***

(a) As per AS - 9, where delivery is made by giving the buyer an unlimited right of return, revenue recognition will be based on the substance of the agreement.

(b) The above Publisher - Distributor agreement may be effectively considered as an consignment agreement where the Distributor sells the books and returns the unsold stock to the Principal, i.e. Publisher.

3. ***Conclusion:***

(a) Revenue can be recognised by the Publishing Company, only when books are finally sold by the Distributor to the customers.

(b) For the Distributor, it is effectively an agency agreement and hence his revenue consists of the 7.5% Commission on the value of books sold to customers.

Question 13

Maharudra Research Services (MRS) has received two lakh subscriptions during the current year under its new scheme whereby customers are required to pay a sum of Rs. 3,000 for which they will be entitled to receive 'Jeevadhar' (a magazine) for a period of 3 years. MRS wants to treat the entire amount as revenue for the current year. Comment.

1. Basis: *Revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.*

2. ***Recognition:*** *Revenue received or billed should be deferred and recognized, - (a) either on a straight line basis over time or, (b) where the items delivered vary in value from period to period.*

3. ***Conclusion:*** *The accounting treatment adopted by MRS is not in accordance with AS - 9. The revenue should be recognised on a straight-line basis, in the above case.*

Question 14

Like Thinkers Society (LTS) receives an entrance fee of Rs. 5,000 from new members. Members are also required to pay a Membership Fees of Rs. 1,500 at the time of entrance. The membership fee permits only membership and all other services or products are paid for separately. Give the accounting treatment for entrance fees and membership fees.

1. ***Entrance Fees:*** *Entrance Fee of Rs. 5,000 received from new members should be capitalised.*

2. ***Membership Fees:*** *If the Membership Fee permits only membership and all other services or products are paid for separately, or there is a separate annual subscription, the fee should be recognised when received. Hence, the amount of Rs. 1,500 should be treated as revenue when received.*

Question 15

Saritha Publications publishes a monthly magazine on the 15th of every month. It sells advertising space in the magazine to advertisers on the terms of 80% sale value payable in advance and the balance within 30 days of the release of the publication. The sale of space for the March 2017 issue was made in February 2017. The Magazine was published on its scheduled date. It received Rs. 2,40,000 on 10.03.2017 and Rs.60,000 on 10.04.2017 for the March 2017 issue. Discuss in the context of AS-9 the amount of revenue to be recognized and the treatment of the amount received from advertisers for the year ending 31.03.2017. What will be the treatment, if the publication is delayed till 02.04.2017?

1. Advance of Rs. 2,40,000 received and the amount balance to be received on 10.04.2017 of Rs. 60,000 shall be recognized in the financial year ending on 31.03.2017 as the publication appears before public on 10.03.2017 (within the FY).

2. If the publication is delayed and the advertisement appears only on 02.04.2017, the Income of Rs. 2,40,000 should be recognized as Revenue only in Financial Year 2017-2018. The amount received on 10.03.2017 should be disclosed as an Advance Received on 31.03.2017.

AS-17: SEGMENT REPORTING

CA TEJAS SUCHAK
ACCOUNTANCY ACE

OBJECTIVES

To establish principles for reporting financial information about:

1. Different types of products & services an enterprise produces.
2. Different geographical areas in which in operates.

TYPES OF SEGMENTS

BUSINESS SEGMENTS

Is a distinguishable component of the enterprise:-

-That in engaged in providing an individual product or service or a group of related product or service &

-That is subject to risks & returns that are different from those of other business segments.

GEOGRAPHICAL SEGMENT

Is distinguishable component of the enterprise that is:

-Engaged in providing products or services within a particular economic environment

-That is subject to risks and returns that are different from those of components operating in other economic environments.

FACTORS

Factors that determine products or services are related:

1.Nature of products or services.
2.Nature of production processes.
3.Type/class of customers for products or services.
4.Methods used to distribute products or services eg: sole selling agency, digital marketing.
5.Nature of the regulatory environment. Eg: Banking, Insurance etc.

FACTORS

Factors considered to identify geographical segments include:

1.Similarity of economic & political conditions.
2.Relationships between operations in different geographical areas.
3.Special risks related to operations in a particular area.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

SEGMENT REVENUE & SEGMENT EXPENSE

SEGMENT REVENUE

1.Portion of enterprise revenue directly attributable to a segment.

2.Relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment.

3.Revenue from transactions with other segments of an enterprise.

SEGMENT EXPENSE

1.Expense resulting from operating activities directly attributable to the segment.

2.Relevant portion of the enterprise expense that can be allocated on a reasonable basis to the segment.

3.Expense relating to transactions with other segments of the enterprise.

EXCLUDES

1.Extraordinary items as per AS-5.

2.Interest or dividend income including interest earned on advances or loans to other segments.

3.Gains on sale of investment or extinguishment of debt.

NOTE: items 2. & 3. Above are includible if the operations of the segment are primarily of financial nature.

EXCLUDES

1.Extraordinary items as per AS-5.

2.Interest expense including interest incurred on loans & advances from other segments.

3.Losses on sale of investments or losses on extinguishment of debt.

4.Income tax expense.

5.General administration expense, head office expense & other expense that arise and relate to the enterprise as a whole.

NOTE: Items 2. & 3. Above become includible if the segments operation are primarily of a financial nature.

SEGMENT ASSETS & SEGMENT LIABILITIES

SEGMENT ASSETS

Operating assets of a segment are those that are:-

1.Directly attributable to a segment.

2.Can be allocated to the segment on a consistent basis.

Eg: current assets, tangible fixed assets, intangible fixed assets used in operating activities of a segment.

SEGMENT LIABILITIES

Operating liabilities that result from the operating activities of a segment and that are either:-

1.Directly attributable to a segment.

2.Can be allocated to the segment on a reasonable basis.

Eg: trade and other payabless, customers advances, warranty provisions.

AS-17: SEGMENT REPORTING

CA TEJAS SUCHAK
ACCOUNTANCY ACE

INCLUDED ITEMS

-Receivables, loans, investments, interest or dividend generating assets (when segment income includes related interest or dividend income.)

-Depreciable assets when depreciation is included in segment expense.

-Operating assets shared by two or more segments when a reasonable basis for allocation exists.(When related revenue or expense are reasonably allocated to their segments.)

-Goodwill when it is directly attributable to a segment or it can be allocated on a reasonable basis.

INCLUDED ITEMS

-Interest payable; when segment result includes related interest expense.

CAN INTEREST EXPENSE BE IDENTIFIED TO A PARTICULAR SEGMENT

Only if;

-Operations of the segment are primarily of financial nature.

-Interest is included as part of cost of inventories, as required by AS-16, read with AS-2 and those inventories are a part of segment assets.

REPORTABLE SEGMENTS

Identified based on:

SEGMENT REVENUE CRITERION

-Segment revenue>= 10% total revenue of all segments.

-Total revenue= external sales + inter segment sales.

SEGMENT ASSETS CRITERION

-Segment assets >= 10% of total segment assets.

SEGMENT RESULT CRITERION:

Segment results >=10% of

1.Combined result of all segments in profit.
2.Combined results of all segments in loss.
Whichever is greater in absolute terms.

IMPORTANT POINTS:

1. **75% REVENUE PRINCIPLE**: If total external revenue attributable to reportable segments constitutes < 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they donot meet the 10% criteria mentioned above until atleast 75% of the total enterprise revenue is included in reportable segments.

2. **CONTINUITY PRINCIPLE**: A segment identified as reportable segment in the immediately preceeding period upon satisfaction of the 10% treshholds, continues to be a reportable segment for the current period notwithstanding that its revenue, assets, results no longer meet the 10% criteria.

IDENTIFICATION OF SEGMENT REPORTING FORMAT:

Risks & Returns are predominantly affected by

DIFFERENCES IN PRODUCTS & SERVICES PRODUCED BY THE ENTERPRISE;

Primary reporting= business segments

OPERATIONS IN DIFERENT COUNTRIES OR GEOGRAPHICAL AREAS

Primary reporting= geographical segments.

Question 1

Raju Ltd Produces batteries for scooters, cars, trucks and specialized batteries for invertors and UPS. How many segments should it have and why?

Answer

As per AS 17, Business segment is a distinguishable component compared to other components in its risks & returns and the products/services providing.

In this given case, the basic product of the company is batteries, but the risks and returns of the batteries for Automobiles (Scooters, cars, trucks) are different from the batteries for Invertors and UPS by considering the following factors.

In the case of Automobile batteries, the risks and returns are affected by the Government policy, road conditions, quality of auto mobiles, etc. whereas in case of batteries for invertors and UPS, the risks and returns are affected by power condition, standard of living, etc.

Hence, the company has two segments, namely "Automobile Batteries" and "Batteries for Invertors and UPS"

Question 2

Raju Ltd. manufactures two products "X" and "Y" and it sells the first one to customers on credit basis and the later one on cash basis. Both X & Y do not differ significantly in terms of risks and returns. Can the entity present as two segments like 'cash sales' and 'credit sales'?

Answer

Business segment is the one which is different in risks and returns of the products/service producing. But in the given case, as they do not differ significantly in risks and returns it cannot be presented as two segments and it can be grouped as one segment.

Question 3

Rama Ltd. sells 70% of goods in India and the balance is exported to Europe countries. They would like to identify two geographical segments like 'Local sales' and 'export sales'. Comment please.

Answer

As per AS 17, geographical segment is the one which is different in risks and returns of economical environment. It can be determined based on location of assets or location of customers.

In the given case, the entity's customers are located in India and Europe countries. As the sales to Europe countries are material (30%), the entity can identify the two segments of Local sales and export sales. It is in compliance of the standard.

Question 4

Hari Ltd. deals with only laptops manufacturing and spares in India. Sales and assets related to Spares are insignificant. Does it need to present segment reporting?

Answer

As per AS 17, if the entity has only either one business segment OR geographical segment, segment information as per the standard is NOT required. However, the fact that there is only one business or geographical segment should be disclosed by way of a note.

Question 5

Compute Segment revenue and Enterprise Revenue for the following segments:

	Rs.
Division A:	
Sales to Division B	*3,050*
Other sales (Domestic sales)	*60*
Export sales	*4,090*
Division B:	
Sales to Division C	*30*
Export sales to Europe	*200*
Division C:	
Export sales to US	*250*
Interest received on Fixed deposits (which are made by Division A	*50*
Dividend income	*250*
Profit on sale of investments in ABC Ltd. shares	*100*

Answer:

Calculation of Segment Revenue:

	Division A	*Division B*	*Division C*
Domestic sales	*60*	*-*	*-*
Export sales	*4,090*	*200*	*250*
External Sales	*4,150*	*200*	*250*
Inter segment sales	*3,050*	*30*	*-*
Segment Revenue	*7,200*	*230*	*250*

Enterprise revenue is a revenue from external customers and it does not include inter segment transfers.

So Enterprise revenue = 4,150 + 200 + 250 = 4,600

Note: As per AS 17, Segment revenue should include Interest, dividend and profit on sale of investment in shares only when the segment is primarily of financial nature. In the given case as there are sales and export sales exist, we understood that the segments are NOT of financial *nature and it is NOT included in segment revenue.*

Question 6

Compute Segment expense for the following segments:

Particulars	*Rs.*
Foods Division expenses	*4,500*
Packing division expense	*2,500*
Health division expense	*3,500*
Manager's salary who works for all the divisions (spends equal time for all divisions)	*300*
General corporate expenses	*550*
Interest on loan taken for the purpose of Foods division	*50*
Loss on sale of investments in XYZ Ltd.	*150*
Loss on earthquake (uninsured)	*100*

***Answer**.*

*I suggest you to go through the 'segment expense' definition before you **Answer** this question.*
Calculation of Segment Revenue:

	Foods	*Packing*	*Health*
Expenses directly attributable to division	*4,500*	*2,500*	*3,500*
Allocable expense on reasonable basis Manager's salary (allocate in 1:1:1 ratio)	*100*	*100*	*100*
Total segment expense	*4,600*	*2,600*	*3,600*

Notes'.

(1) As per AS 17, Segment expense should include loss on sale of investment in shares only when the segment is primarily of financial nature. Based on the names of divisions it is understood that the segments are NOT of financial nature and it is NOT included in segment expense.

(2) In the given case, Interest expense incurred by the entity is NOT of operating nature (even though it is related to a specific segment), hence it is not included in the segment expenses.

(3) Loss on earthquake is an extraordinary item hence it is not included in segment expense.

Question 7

X Ltd is into two segments namely 1. Banking & 2. Health. The entity wants to present the interest income and expense under Finance segment. Comment.

Answer

As per AS 17, Segment revenue and expense should include Interest income and expense only when the segment is primarily of financial nature. In the given case the banking segment is of financial nature, hence interest income and expense should be part of segment income and expense.

Question 8

Harsha Ltd. has two segments namely Cement production & Construction. The company has few lorries which are used in carrying cement as well as in construction, which will be in the ratio of 60:40 respectively. The management of the company wants to present the lorries under cement segment as it is used majorly in that segment. Comment.

Answer

As per the definition, segment assets are operating assets which are directly attributable to the segment OR which can be allocated to the segment on reasonable basis;

In the given case, the lorries are used for the operating purposes, hence they are segment assets. As they are not specifically used for one segment, it can be allocated to both segments on reasonable basis which is 60:40. At the same time depreciation expense should also be apportioned under segment expense in the same proportion.

Question 9

Sunita Ltd. has taken bank overdraft for the purpose of one of its segments (Cement segment); and it incurred interest expense. Can the entity allocate this Bank overdraft as segment liability and Interest expense as segment expense?

Answer

As per the Standard, segment expense is the operating expense which is arising from the operating activities of the segment i.e. for operating activities. Interest on either overdraft or any loans is a FINANCING ACTIVITY and not an operating activity. Hence it should NOT be a part of operating expense. As interest is not a segment expense, overdraft cannot be an operating liability and hence it cannot be allocated as part of segment liabilities.

Interest and overdraft can be part of Segment reporting when:

(a) The segment is primarily of financial nature; or

(b) Interest can be added to the cost of inventories only where time is the major factor in bringing about a change in the condition of inventories (Qualifying asset as per AS 16 - which takes substantial period of time to make it ready for sale).

Change in the condition of inventories is an operational activity. Accordingly, such interest is resulting from the operating activities of the segment in respect of which such inventories constitute the segment asset. Hence interest on such inventories should be considered as a segment expense.

Question 10

(CA final Audit - May 2002 & Accounts May 2006)

Following is the data regarding six segments of Z Ltd. (Rs.In '000)

Particulars	A	B	C	D	E	F	Total
Segment Revenue	150	310	40	30	40	30	600

Segment Result	*25*	*(95)*	*5*	*5*	*(5)*	*15*	
Segment Assets	*20*	*40*	*15*	*10*	*10*	*5*	*100*

The Finance Director is of the view that it is sufficient that segments A and B alone will be reported. Advise

Answer

A Segments will be treated as reportable segment if satisfies any ONE of the 5 conditions discussed above.

1. Segment Revenue Criteria'.

A segment is reportable only when segment revenue is > 10% total segment revenue i.e. 60 (T600 x 10%); Segments A & B satisfy the criteria - Hence they are reportable segments under this criteria;

2. Segment Results criteria:

A segment is reportable only when segment results are > 10% of total segment revenue either total profit (Rs.50) OR Total loss 100) in absolute numbers whichever is higher i.e. Rs.10 (100 x 10%)

Segment A, B & F satisfies the condition. Hence they are reportable segments;

3. Segment Assets criteria:

A segment is reportable segment assets > 10% of total assets of all the segments i.e. 10 (Z100 x 10%) Segment A, B, C, D & E satisfies the condition. Hence they are reportable segments;

4. Management discretion: As it is not mentioned in the question - it is ignored.

5. Overall revenue criteria:

Total reportable segments external revenue should be > 75% of the enterprise revenue i.e. Rs.450 (600 x 75%)

As all segments are identified as reportable segments, we need not look at 75% criteria, hence management's view is not correct.

Question 11

M/s XYZ Ltd. has three segments namely X, Y, Z. The total assets of the Company are Rs. 10.00 cr. Segment X has Rs.2.00 cr., segment Y has Rs.3.00 cr. and segment Z has Rs.5.00 cr. Deferred tax assets included in the assets of each segments are X - Rs.0.50 cr, Y - Rs.0.40 cr. and Z—Rs.0.30 cr. The accountant contends that all the three segments are reportable segments. Comment.

(CA Final -Nov 2014 & CA Inter May 2018)

Answer

As per the definition of segment assets, income-tax assets are EXCLUDED. Hence the deferred tax asset amounts should be eliminated from the segment assets.

Therefore, the revised total assets are 8.8 crore [10 crore - (0.5+0.4+0.3)]. Segment X holds total assets of 1.5 crore (2 crore - 0.5 crore); Segment Y holds 2.6 crore (3 crore - 0.4 crore); and Segment Z holds 4.7 crore (5 crore - 0.3 crore).

Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Question 12

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A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?

Answer

As per AS 17, inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. The company can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently.

In the given case, inter-segment transfer pricing policy adopted by the company is correct if followed consistently.

AS-18: RELATED PARTY DISCLOSURES

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APPLICABILITY:

- Entities whose securities (debt/equity) are listed or are in the process of listing (evidenced by the resolution of board of directors resolution).
- Commercial industrial, business reporting entities, whose turnover for the accounting period exceeds Rs.50 cr.

NON APPLICABILITY

- If disclosure under this standard affects entity's duties of confidentiality.
- A statute/regulator/similar competent authority governing an entity prohibit disclosing certain information.
  Eg: Banks are obliged to maintain confidentiality regarding customers' transactions.
  (logic- AS does not override the law)
- In consolidated financial statements, Intra Group Transactions need not be presented as CFS present information as a single reporting entity.
- State Controlled Enterprise need not disclose relationship & transactions with other state controlled enterprise.

DEFINITIONS

RELATED PARTY RELATIONSHIPS:

Parties are considered as 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 & or operating policy decisions.

RELATED PARTY TRANSACTIONS:

Is a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

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RELATED PARTY RELATIONSHIPS

1. CONTROL

1. Entities, that directly or indirectly through one or more intermediaries,

- control, or *ENTITY A(R.E.) → CONTROLS → ENTITY B(R.P)*
- are controlled by, or *ENTITY C(R.P.) → CONTROLS → ENTITY A(R.E)*
- are under common control with the reporting entity.

ENTITY C → CONTROLS → ENTITY Z(R.P) & ENTITY A(R.E)

CONTROL MEANING: Power to decide financial or operating policies of an entity. Comes with:

- More than 50% voting power either directly or indirectly.
- Controlling the composition of the governing body of the entity.
- Substantial interest in the voting power & POWER TO DIRECT financial or operating policies of the entity either directly or indirectly.

CONTROL OF COMPOSITION OF BoD

- Only when all or majority of the directors cannot be removed or appointed without the permission of the entity.(A ltd.)
- A person is appointed as a director/ member of the governing body of the R.E. only because he holds a position(manager/director) in the controlling entity. (A ltd.)
- A director in R.E. is nominated by the company (A ltd.) or its subsidiary.

SUBSTANTIAL INTEREST

An Entity has substantial interest in another entity only when it owns, directly or indirectly, 20% or more voting power in the other entity.

2. ASSOCIATES & JOINT VENTURES

1. Associates & Joint Ventures of the reporting entity and

   ENTITY A(R.E.)→ASSOCIATE/JOINT VENTURE→ENTITY B(R.P.)

2. The investing party or the venturer in respect of which the reporting entity is an associate or a joint venture.

   VENTURER 1(R.P.)→INVESTS IN→ENTITY A(R.E.) :-JOINT VENTURE RELATION

   INVESTOR 1 (R.P.)→INVESTS IN→ENTITY A(R.E.) :-ASSOCIATE RELATION

ASSOCIATE

Associate is an entity in which investing party has a SIGNIFICANT INFLUENCE on the entity.

JOINT VENTURE

Is an economic activity, which is jointly controlled by two or more parties as per the contractual arrangement.

SIGNIFICANT INFLUENCE

- Right to participate in the financial or operating policies decisions of the enterprise but not control of these policies. Investing party can influence the decision making process.

HOW CAN SIGNIFICANT INFLUENCE BE GAINED

- **Share Ownership** :- If entity has 20% or more voting power.
  - If despite owning >=20% shares, the entity does not exercise significant influence the same will have to be proved.
  - If the entity does not own >=20% shares, and still exercises significant influence the same again needs to be proved by the entity.
- **Statute**
- **Agreement**

NOTE:- If an entity has a majority voting power in the reporting enterprise(i.e. it controls the reporting enterprise), this does not restrict the investing party from exercising significant influence.

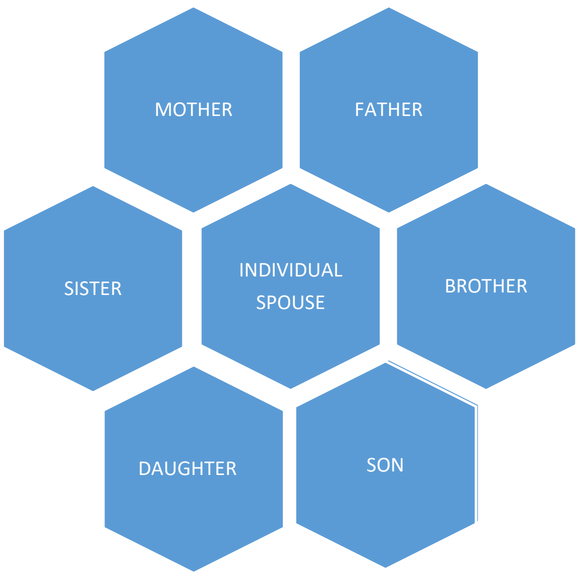
EXAMPLES:-

1. Investor's representative in the board of the associate.
2. Participation in policy making process
3. Material transactions between the investor & associate
4. Interchange of managerial personnel.
5. Technical assistance required by the associate provided by the investor.

3. INDIVIDUALS

- Individuals who have control or who can exercise significant influence on the reporting entity &
- Relatives of such individuals.

RELATIVES:



4. KEY MANAGERIAL PERSON

- Key managerial person &
- Relatives of such key managerial person.

KEY MANAGERIAL PERSON: MEANING:-

Who have
Authority & responsibility for
-Planning
-Directing
-Controlling
the activities of the entity.
Example: Managing Director, Whole Time Director, Chief Executive officer etc.

5. RELATED ENTITY

An entity will be related party of the reporting entity if the persons mentioned in point 3.(INDIVIDUALS) & 4.(KMP) Are able to exercise significant influence on it.

ENTITY A (R.E.)<--(S.I/CONTROL/KMP) <--MR.X-->S.I.-->ENTITY B(R.P.)

DISCLOSURES

- Where there is control;
  - Name of related party.
  - Nature of related party relationship.
    (Even if no transactions have taken place.)

NOTE: This disclosure is required only when there is control.

- If there have been transactions between the related parties during the existence of related party relationship; following disclosures should be made;
  - Name of related party.
  - Description of the relationship.
  - Description of the nature of transactions.
  - Volume of transactions.
  - Outstanding amounts pertaining to related parties at the B/S date, provisions for doubtful debts for such parties.
  - Amount written off in the period in respect of bad debts due.

Question 1

Adhiram Ltd has a Corporate Communications Department, which centralises the Public Relations function for the whole group of Adhiram Ltd and its Subsidiaries. No charges are, however, levied by Adhiram Ltd on its Subsidiaries and accordingly, these transactions are not given accounting recognition. Would these constitute Related Party Transactions requiring disclosure under AS -18 in the Separate Financial Statements of Adhiram Ltd?

*1. **Principle:** As per AS - 18, a Related Party Transaction is "a transfer of resources or obligations between related parties, regardless of whether or not a price is charged".*

*2. **Conclusion:** In the given example, there is a transfer of resources from Adhiram Ltd to its Subsidiaries even though no price is charged for the same. These transactions would require disclosure under AS - 18 in the Separate Financial Statements of Adhiram Ltd.*

Question 2

Bhanu Ltd is a 100% subsidiary of Agni Ltd. Which of the following are considered as Related Party Transactions for the purpose of Consolidated Financial Statements?

Situation	***Whether Related Party Transaction or not, for CFS***
Salary paid to Employees of Bhanu Ltd.	• *Salaries and Loans given to Employees are in the course of normal dealings of business.*
Loans given to Employees of Agni Ltd.	• *Also, Employees are not considered as Related Party for an Entity.*
Inter-Company Sales between Agni Ltd and Bhanu Ltd.	• *Holding and Subsidiary Companies are Related Parties, since they are said to be under common control for the purpose of Consolidated Fin.Statements. However, no disclosure is required for Inter-Company Sales between Holding and Subsidiary, in the Consolidated Fin.Statements. [Para 7]*
Loan given by Bhanu Ltd to Managing Director of Agni Ltd.	• *Since, Managing Director of Agni Ltd directly or indirectly owns an interest in the voting power of the Reporting Enterprise that gives him control or significant influence over its subsidiary Bhanu Ltd, the loan given to him by Bhanu Ltd will be treated as Related Party Transaction.*
Transfer of Asset by Agni Ltd to Bhanu Ltd.	• *Since, Holding and Subsidiary Companies are Related Parties as per Para 3(a), transfer of asset by Holding Company Agni Ltd to its Subsidiary Bhanu Ltd will be considered as Related Party Transaction.*

Question 3

Bhima Ltd sold to Arjun Ltd, goods having a Sale Value of Rs. 25 Lakhs during a Financial Year. Mr.Strength, the Managing Director and Chief Executive of Bhima Ltd owns nearly 100% of the Capital of Arjun Ltd. The Sales were made to Arjun Ltd at the normal Selling Price of Bhima Ltd. The Chief Accountant of Bhima Ltd does not consider that these Sales should be treated any differently from any other sale made by the Company despite being made to a Controlled Company, because the sales were made at normal and, that too, at arms' length prices. Comment.

*1. **Principle - 1:** Related Party Relationship covers the following relationships -*

(a) Enterprises that control the Reporting Enterprise,

(b) Enterprises that are controlled by the Reporting Enterprise, or

(c) Enterprises that are under common control with the Reporting Enterprise (this includes Holding Companies, Subsidiaries and fellow Subsidiaries),

*2. **Principle - 2:** Further, AS - 18 is applicable irrespective of whether or not the transactions with related parties are made at arm's length prices.*

*3. **Analysis:** Hence, in the given case, Bhima Ltd has Related Party Relationship with Arjun Ltd since both the Companies under the common control of a single person (Mr.Strength).*

*4. **Conclusion:** Hence, Bhima Ltd should disclose the information required under AS - 18 in relation to its Sales to Arjun Ltd during the entire Financial Year.*

Question 4

A husband and wife are controlling 34% of voting power in Mathura Limited. They have a separate Partnership Firm, which supplies the main Raw Material to the Company. The Management says that the above transaction need not be disclosed. How will you deal with the above situation?

*1. **Related Party Relationship:** The definition of Related Party Relationship covers "Enterprises owned by the Directors or Major Shareholders of the Reporting Enterprise."*

*2. **Significant Influence:** Significant Influence is **presumed** to exist, if an investing party holds 20% or more of the voting power of the Enterprise (Such holding may be direct or indirect through Intermediaries).*

*3. **Disclosure:** AS - 18 requires disclosure if there have been transactions between Related Parties, irrespective of whether or not the transactions have been entered into at arm's length prices.*

*4. **Conclusion:** In the instant case, the individuals hold 34% of the voting power in the Company, and hence have a significant influence. Disclosure is required as per AS - 18.*

Question 5

A Firm of a Father and Son received Rs. 2 Lakhs towards job work done for Rama Ltd, during the year ended 31st March. The total Job Work Charges paid by Rama Ltd during the year are over Rs. 50 Lakhs. The father is a Managing Director of Rama Ltd having substantial holding. The Managing Director told the Auditor that since he is not involved in the activities of the Firm, and since the amount paid to it is insignificant, there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is the M.D. right in his approach?

1. Principles:

*(a) 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 decisions.*

*(b) As per AS -18, **Significant Influence** is said to exist in case the investing party has 20% or more voting power in the Enterprise.*

*2. **Analysis and Conclusion:** In the above case, the Managing Director of Rama Ltd is a Partner in the Firm with his son, and the Firm has been paid Rs. 2 Lakhs as Job Work Charges. The Managing Director has a substantial holding in the Firm. The Managing Director is also a Key Management Personnel of Rama Ltd. Hence, there is a Related Party relationship & transaction, requiring disclosure under AS - 18.*

Question 6

Vamana Ltd has two Non-Executive Directors in its Board. State whether AS -18 is applicable if - (1) A, a Non-Executive Director is in a position to exercise significant influence by virtue of owning an interest in the voting power in the Company. (2) B, a Non-Executive Director does not enjoy the authority and responsibility for planning, directing and controlling the activities of the Company.

*1. **Principle:** AS - 18 applies to Non-Executive Director as under:*

AS - 18 not applicable	***AS -18 applicable***
*(a) A Non-Executive Director of a Company should **not** be considered as Key Management Person under AS - 18 by virtue of his **merely** being a Director, **unless** he has the authority and responsibility for planning, directing and controlling the activities of the Reporting Enterprise.* *(b) AS - 18 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. **(Note:** Mere participation is different from authority to plan / direct / control)*	*A Non-Executive Director would be covered by AS - 18 if he is a Key Management Person, when -* *(a) he has the authority and responsibility for planning, directing and controlling the activities of the Reporting Enterprise, or* *(b) he is in a position to exercise control or significant influence by virtue of owning an interest in the voting power.*

Question 7

P Ltd owns 60% of the voting power of Q Ltd. Q Ltd in turn owns 70% of the voting interest in R Ltd. Further, P Ltd also directly owns 15% of the voting interest in R Ltd. Would P Ltd be deemed to have control over R Ltd or would it only be considered as exercising significant influence?

1. Principle:

*(a) If a Parent owns along with its Subsidiary more than one-half of the voting power in an enterprise, that Enterprise will be considered as a Related Party of the Parent, by virtue of the ability to **control.***

(b) As per AS - 18, Control includes ownership, directly or indirectly, of more than one-half of the voting power of another enterprise.

***Control:** P Ltd is a majority Shareholder (60%) in Q Ltd and it has control over it. Also, P Ltd and Q Ltd, together are majority shareholders (15% + 70% = 85%) in R Ltd. Thus, P Ltd has indirect control over R Ltd.*

*4. **Conclusion:***

*(a) In the given case, P Ltd has the ability to **control** R Ltd, based on the holding of more than one-half of the voting power.*

*(b) Hence, P Ltd has **control** over R Ltd and not just significant influence.*

Question 8

Arun Ltd owns 60% of the voting power of Baskar Ltd, which in turn owns 60% voting interest in Chandru Ltd. Karuna Ltd owns the remaining voting share in Chandru Ltd and is considered to exercise significant influence over Chandru Ltd. During the reporting period, Karuna Ltd enters into transactions in the ordinary course of business with Arun Ltd. Would Karuna Ltd be a Related Party of Arun Ltd?

*1. **Analysis:** Karuna Ltd is **not related** to Arun Ltd as it - (a) neither controls nor is controlled by Arun Ltd, (b) does not exercise significant influence over Arun Ltd or is **not** so influenced by it.*

*2. **Conclusion:** Hence, Arun Ltd and Karuna Ltd are not considered as related party for the purpose of AS - 18.*

Question 9

Achyuta Ltd acquired 12% voting power in Govinda Ltd. Achyuta, being the single largest shareholder of Govinda, appoints the Chairman and one other Member of the Board of Directors of Govinda Ltd (out of a total of 12 Directors). These nominees of Achyuta Ltd are not Directors of Achyuta Ltd. By virtue of its representation on the Board (through two nominees) of Govinda Ltd, Achyuta participates in the financial and operating policy decisions of the enterprise taken at the Board Meetings. Would Achyuta be considered as exercising control over Govinda Ltd?

*1. **Control:** In this case, since the Shareholding is only 12%, Achyuta Ltd does **not** have the **ability to control** Govinda Ltd. Also, there is no agreement or statute, which gives Achyuta Ltd, the power to direct the policies of Govinda Ltd.*

*2. **Significant Influence:** As per AS - 18, when an enterprise owns less than 20% voting power in the other enterprises there is **no** significant influence **unless the contrary is proved.***

*3. **Conclusion:** In the above case, being the single largest shareholder, Achyuta Ltd participates in the financial and operating policy decisions of Govinda Ltd. So, it is clearly demonstrated that Achyuta has significant influence over Govinda Ltd. Therefore, Govinda Ltd **is a Related Party** of Achyuta Ltd, even if 20% voting power is not satisfied.*

Question 10

A Ltd owns 30% of the Equity Capital of B Ltd. B Ltd in turn owns 35% of the Equity Capital of C Ltd, and 40% of Equity Capital in D Ltd. Answer the following questions

(1) Is B Ltd a Related Party to A Ltd? (2) Is C Ltd a Related Party to A Ltd? (3) Are C Ltd and D Ltd are Related Parties?

1. Associates and Joint Ventures of the Reporting Enterprise are Related Parties. Since A Ltd holds more than 20% of the voting power in B Ltd, by virtue of this, it has substantial interest and significant influence in B Ltd. So, B Ltd is an Associate, and hence is Related Party to A Ltd.

*2. An Associate of an Associate is **not** a Related Party. Only in the case of a Holding Company, a Subsidiary of a Subsidiary (Sub-Subsidiary) also becomes a Related Party.*

*3. C Ltd and D Ltd are Co-Associates. Co-Subsidiaries become Related Parties because of common control. In the case of Co-Associates, this common control is missing, and therefore they are **not** Related Parties.*

AS-19: LEASES

CA. TEJAS SUCHAK
ACCOUNTANCY ACE

ACCOUNTING OF LEASES

FINANCE LEASE

IN THE BOOKS OF LESSOR

-**ASSET:** Lease receivable, recognised @ net investment in the lease.
-**INCOMES:** Finance income
-**INITIAL DIRECT COSTS:**

MANUFACTURER/ DEALOR LESSOR	OTHER LESSOR
Charged to P&L.	-Either charge to P&L, -Or allocate over lease term

IN THE BOOKS OF LESSEE

-**ASSET:** Asset that is taken on lease, recognised @ lower of:

- PV of MLP.
- Fair value of the asset.

-**LIABILITY:** Lease payable
-**EXPENSE:** Depreciation + finance(interest) expense
-**INITIAL DIRECT COSTS:** To be capitalised.

OPERATING LEASE

IN THE BOOKS OF LESSOR

-**ASSET:** Asset which is given on lease (Fixed Asset).
-**INCOME:** Lease rent
-**EXPENSE:** Depreciation
-**INITIAL DIRECT COSTS:**
-Either charge to P&L,
-Or allocate over lease term

IN THE BOOKS OF LESSEE

-**EXPENSE:** Lease rental.
-**INITIAL DIRECT COSTS:** Charge to P&L immediately.

SALE & LEASEBACK TRANSACTIONS

This involves sale of an asset by a vendor and then taking on lease the same asset back from the purchaser.

FINANCE LEASE

In case of sale & leaseback transactions that results in a finance lease, any excess/deficiency which results from the sale of the asset should be deferred & recognised as income/loss in the financial statements in proportion to depreciation.

CA. TEJAS SUCHAK
ACCOUNTANCY ACE

OPERATING LEASES

SALE PRICE = FAIR VALUE		SALE PRICE > FAIR VALUE		SALE PRICE< FAIR VALUE	
SP=CA	No profit/loss on sale.	SP=CA	1.Charge loss i.e. FV-CA to P&L. 2.Profit i.e. SP-FV should be treated as deferred income.	SP=CA	No profit/loss on sale.
SP<CA	Loss charged to P&L i.e. CA-SP.	SP<CA	1.Charge loss i.e. FV-CA to P&L. 2.Profit i.e. SP-FV should be treated as deferred income.	SP<CA	Charge loss to P&L i.e. CA-SP. If, however, such loss is compensated by lower lease payments, then defer it in proportion to lease payment.
SP>CA	Profit credited to P&L i.e. SP-CA.	SP>CA	1.Profit i.e. SP-FV should be treated as deferred income.	SP>CA	Profit credited to P&L i.e. SP-CA.

AS-19: LEASES

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INCEPTION OF THE LEASE

Earlier of:

- Date of lease agreement
- Date of commitment by parties to principle provisions of lease.

ECONOMIC LIFE

- Period over which asset is expected to be economically useful by one or more users.
- The no. of production or similar units expected to be obtained from the asset by one or more users.

USEFUL LIFE

- Period over which asset is expected to be used by the lessee.
- No. of production or similar units expected to be obtained from the use of the asset by the lessee.

RESIDUAL VALUE

- Estimated fair value of the asset at the end of the lease term.

GROSS INVESTMENT IN THE LEASE

- Total of minimum lease payment from the point of lessor and unguaranteed residual value.
- This is calculated only from lessor's point of view.

UNEARNED FINANCE INCOME

- It is the difference between gross investment in the lease and the net investment in the lease.
- This is calculated only from lessor's point of view.

LESSSEE'S INCREMENTAL RATE OF BORROWING

- Rate of interest that the lessee would have to pay on a similar lease.
- If that is not determinable, then, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, to purchase the asset.

MINIMUM LEASE PAYMENTS

LESSEE'S POINT OF VIEW: Payments over the lease term that the lessee is required to make. (excludes contingent rent, cost of services to be paid by & reimbursed to the lessor.)

ADD: residual value guaranteed by or on behalf of the lessee.

LESSORS POINT OF VIEW: Payments over the lease term that the lessee is required to make. (excludes contingent rent, cost of services to be paid by & reimbursed to the lessor.)

ADD: residual value guaranteed by or on behalf of the lessee.

ADD: residual value guaranteed by an independent third party capable of meeting the guarantee.

UNGUARANTEED RESIDUAL VALUE

- Amount by which total residual value of the asset exceeds the guaranteed residual value.

=Total residual value – Guaranteed residual value.

NET INVESTMENT IN THE LEASE

It is the **PV** of

- Total of minimum lease payment from the point of lessor and unguaranteed residual value.
- This is calculated only from lessor's point of view.

INTEREST RATE IMPLICIT IN THE LEASE

- It is the discount/interest rate that at the inception of the lease causes the net investment in the lease to be equal to the fair value of the asset.

LEASE TERM

It is the non-cancellable period for which the lessee has agreed to take the asset on lease.

NON-CANCELLABLE LEASE

Lease that is cancellable only:

- upon occurrence of remote contingency.
- with permission of lessor.
- If new lease for equivalent asset entered with same lessor.

AS-19: LEASES

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ACCOUNTANCY ACE

NON-APPLICABILITY

This standard does not apply to;

- Lease agreements to explore or use natural resources, such as oil, gas, timber, metals, other minerals: and
- Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents & copyrights; and
- Lease agreements for use of lands.
- Contracts for services that do not transfer the right to use asset from one contracting party to another.

WHAT IS A LEASE

A lease is–
An agreement, whereby,

- Lessor conveys to lessee the right to use an asset, for an agreed period of time,
- In return for a payment or a series of payments.

FINANCE LEASE

A lease that transfers,

- Substantially all the risks & rewards incidental to ownership of an asset.

SUBSTANTIALLY ALL

- The word to be focused on in the above definition is "substantially all".
- This is because, if all the risks & rewards are transferred then it becomes a transaction of outright sale & the question of lease does not arise.

RISKS & REWARDS

RISKS: Possibility of losses from:

- Idle capacity.
- Technological obsolescence.
- Changes in economic conditions.

REWARDS: Expectation of

- Profitable operation over the economic life of the asset.
- Gain from appreciation in value or realisation of residual value.

INDICATORS OF FINANCE LEASE
(Apply the test of SUBSTANCE OVER FORM)

- If Lessor transfers ownership of asset to lessee by the end of the lease term, then FL.
- If the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the Fair value of the asset 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, then FL.
- If Lease Term is for a major part of economic life of the asset, then FL. Major part simply doesn't mean more than 50%, it means substantially the whole life of the asset.
- At the inception of the lease, if the PV of minimum lease payments amounts to at least substantially whole of the fair value of the asset, then FL.
- If the leased asset is of specialised nature such that only the lessee can use it without major modifications being made, then FL.
- If the lessee can cancel the lease & losses accruing to lessor on cancellation are borne by the lessee, then FL.
- If gains/losses from fluctuation to residual value accrue to the lessee, then FL.
- If lessee can continue the lease in the secondary period at a rent which is substantially lower than the market value, then FL.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

Question 1

Under AS -19, how should Penal Interest or Late Payment Charges be accounted for? Will an estimate of Penal Interest or Late Payment Charges be included in Minimum Lease Payments (MLP) for the Lessor?

1. MLP's Receivable by the Lessor and the Lessor's Gross Investment in the Lease are determined ***at the inception of the lease.***

2. Therefore, Penal Interest and Late Payment Charges recoverable from the Lessee in case of default ***cannot*** *form part of MLP. It should be recognized in the books of the Lessor as and when they arise.*

Question 2

Compute the MLP in the following independent situations where Anand and Balu are the Lessor and Lessee respectively -

(1) Monthly Lease Rent = Rs. 25,000, Lease Term = 32 months, Chandru, a third party, provides a guarantee on behalf of Balu to Anand, that Rs. 55,000 will be paid as Residual Value.

(2) Monthly Lease Rent = Rs. 15,000 for 48 months, together with 2.5% of the Sales Revenue per annum, Balu guarantees to pay Anand Rs. 10,000 as Residual Value of the asset.

	Computation	***MLP***
1.	*Total Lease Rent Payable = (Rs. 25,000 × 32 months) = Rs. 8,00,000* *Residual Value guaranteed by a Third Party (Chandru) = Rs. 55,000*	*For Lessor = Rs. 8,55,000* *For Lessee = Rs. 8,55,000*
2.	*Total Lease Rent Payable = (Rs. 15,000 × 48 months) = Rs. 7,20,000* *Residual Value guaranteed by Lessee himself (Balu) = Rs. 10,000* ***Note:*** *Contingent Rent of 2.5% of Sales Revenue is ignored.*	*For Lessor = Rs. 7,30,000* *For Lessee = Rs. 7,30,000*

Question 3

A Machine having expected useful life of 6 years, is leased for 4 years. Both the Cost and the Fair Value of the Machinery are Rs. 7,00,000. The amount will be paid in 4 equal instalments and at the termination of lease, Lessor will get back the Machinery. The Unguaranteed Residual Value at the end of the 4th year is Rs. 70,000. The IRR of the investment is 10%. The Present Value of Annuity Factor of Rs. 1 due at the end of 4th year at 10% IRR is 3.169. The Present Value of Rs. 1 due at the end of 4th year at 10% Rate Interest is 0.683. State with reasons whether the Lease constitutes Finance Lease and also compute the Unearned Finance Income.

Solution:

1. Finance vs Operating Lease

Particulars	***Rs.***

(a) Present Value of Unguaranteed Residual Value (URV)	*Rs. 70,000 × 0.683*	*47,810*
(b) Present Value of Lease Payments (PV of MLP)	*Rs. 7,00,000 - Rs. 47,810*	*6,52,190*
(c) % of PV of MLP to Fair Value	$\frac{Rs. 6,52,190}{Rs. 7,00,000}$	***93.17%***

Conclusion: *The Lease Term is 67%, 4/6th of the Asset's Useful Life, Also, the Present Value of Lease Payments is around 93% of the Fair Value, constituting substantial portion of the Fair Value. Therefore, the Lease is a* ***Finance Lease.***

2. Computation of Unearned Finance Income

Particulars		***Rs.***
	Annual Lease Payments= $\frac{PV\ of\ Lease\ Payments}{Annuity\ Factor\ for\ 3\ years\ at\ 10\%} = \frac{Rs.6,52,190}{3.169}$	*2,05,803 p.a*
Add:	*Total Lease Rentals for the Lease Period = Rs. 2,05,803 p.a × 4 years = MLP Residual Value*	*8,23,212* *70,000*
Less:	*Gross Investment in the Lease* *Present Value of MLP & URV = (6,52,190 + 47,810)* ***(See Note)***	***8,93,212*** *(7,00,000)*
	Unearned Finance Income	***1,93,212***

Note: *PV of MLP & URV equals the Fair Value / Cost of Equipment at the inception of the Lease = Rs.* ***7,00,000.***

Question 4

An Equipment having expected useful life of 5. Years is leased for 3 years. Both the Cost and the" Fair Value of the Equipment are Rs. 6,00,000. The amount will be paid in 3 equal instalments and at the termination of Lease the Lessor will get back the equipment. The Unguaranteed Residual Value at the end of 3 years is Rs. 60,000. The IRR of the investment is 10%. The Present Value of Annuity Factor of Rs. 1 due at the end of 3rd year at 10% IRR is 2.4868. The Present Value of Rs. 1 due at the end of 3rd year at 10% rate of interest is 0.7513. State with reason whether the Lease constitutes Finance Lease and also compute the Unearned Finance Income.

1. Finance vs Operating Lease

Particulars		***Rs.***
(a) Present Value of Unguaranteed Residual Value (URV)	*Rs. 60,000 × 0.7513*	*45,078*
(b) Present Value of Lease Payments (PV of MLP)	*Rs. 6,00,000 - Rs. 45,078*	*5,54,922*
(c) % of PV of MLP to Fair Value	$\frac{Rs. 5,54,922}{Rs. 6,00,000}$	***92.48%***

Conclusion: *The Lease Term is 60%, 3/5th of the Asset's Useful Life. Also, the Present Value of Lease Payments is around 90% of the Fair Value, constituting substantial portion of the Fair Value. Therefore, the Lease is a* ***Finance Lease.***

2. Computation of Unearned Finance Income

Particulars		***Rs.***
	Annual Lease Payments= $\frac{PV\ of\ Lease\ Payments}{Annuity\ Factor\ for\ 3\ years\ at\ 10\%} = \frac{Rs.5,54,922}{2.4868} =$	*2,23,147 p.a*
	Total Lease Rentals for the Lease Period = Rs. 2,23,147 p.a × 3 years = MLP Residual Value	*6,69,441* *60,000*
Less:	*Gross Investment in the Lease* *Present Value of MLP & URV = (5,54,922 + 45,078)* ***(See Note)***	*7,29,441* *(6,00,000)*
	Unearned Finance Income	***1,29,441***

Note: *PV of MLP & URV equals the Fair Value / Cost of Equipment at the inception of the lease = Rs.* ***6,00,000.***

Question 5

Prakash Limited leased a Machine to Badal Limited on the following terms -

Particulars	***Rs. in Lakhs***	***Particulars***	***Rs. in Lakhs***
Fair Value of the Machine	***48.00***	***Guaranteed Residual Value***	***1.60***
Lease Term	***5 years***	***Expected Residual Value***	***3.00***
Lease Rental per annum	***8.00***	***Internal Rate of Return***	***15%***

PVIF for 1 - 5 Year are 0.8696,0.7561,0.6575,0.5718,0.4972. Find Unearned Financial Income.

Year	***Amount***	***PVF at 15%***	***DCF***
1-5	*MLP = 8,00,000*	*0.8696 + 0.7561 + 0.6575 + 0.5718 + 0.4972 = 3.3522*	*26,81,760*
5	*RV = 1,60,000 + 1,40,000 = 3,00,000*	*0.4972*	*1,49,160*
	Gross Investment = MLP + GRV+ URV = ***43,00,000***		***28,30,920***

Unearned Finance Income *= Gross Investment 43,00,000 - PV thereof 28,30,920 = Rs.* ***14,69,080.***

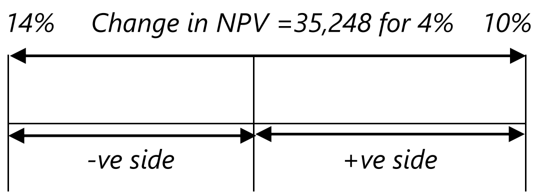
Question 6 ***Calculate the Interest Rate Implicit on Lease from the following details:***

Annual Lease Rent	***Rs. 80,000 at the end of each year***
Lease Period	***5 Years***
Guaranteed Residual Value	***Rs. 40,000***
Unguaranteed Residual Value	***Rs. 24,000***
Fair Value at the inception of the Lease	***Rs. 3,20,000***

Computation of Interest Rate implicit in the Lease

Years	***Particulars***	***CF***	***At 10%***	***Result***	***At 14%***	***Result***
1 to 5	*Annual Lease Rent (ALR)*	*80,000*	*0.909+0.826+0.751+ 0.683+0.621 = 3.790*	*3,03,200*	*0.877+0.769+0.675+ 0.592+0.519 = 3.432*	*2,74,560*
5	*Residual Value (GRV+URV)*	*40,000+24,000 = 64,000*	*0.621*	*39,744*	*0.519*	*33,216*
	Total			*3,42,944*		*3,07,776*
Less:	*Fair Value of Inception of Lease*			*(3,20,000)*		*(3,20,000)*
	NPV / Surplus (Defecit)			*22,944*		*(12,224)*

From the above, i.e. with one +ve NPV and one -ve NPV, IRR is estimated using the number line, as under -



NPV =- 12,224   NPV = 0 (Zero)   NPV= +22,944

Rate Change for 12,224   Rate Change for 22,944

$= \frac{12,224}{35,168} \times 4\% = \mathbf{1.39\%}$, $= \frac{22,944}{35,168} \times 4\% = \mathbf{2.61\%}$

IRR *= 14% - 1.39%* ***(or)*** *10% + 2.61% =* ***12.61%***

Question 7

Lessee Ltd took a Machine on lease from Lessor Ltd, the Fair Value being Rs. 7,00,000. The economic life of the Machine as well as the lease term is 3 Years. At the end of each year Lessee

Ltd pays Rs. 3,00,000. The Lessee has guaranteed a Residual Value (GRV) of Rs. 22,000 on expiry of the lease. However, Lessor Ltd estimates that the Residual Value of the machinery will be only Rs. 15,000. Implicit Rate of Return (IRR) is 15% p.a. and Present Value Factors at 15% are 0.869,0.756 and 0.657 at the end of first, second and third years respectively. Calculate the Value of Machine to be considered by Lessee Ltd and the interest (Finance Charges) in each year

1. Computation of Present Value of Minimum Lease Payments

Year	***Cash Flow Item***	***Cash Flow***	***Discounting Factor***	***PV of Cash Flow***
1	*Annual Lease Rental*	*3,00,000*	*0.869*	*2,60,700*
2	*Annual Lease Rental*	*3,00,000*	*0.756*	*2,26,800*
3	*Annual Lease Rental*	*3,00,000*	*0.657*	*1,97,100*
3	*Guaranteed Residual Value*	*22,000*	*0.657*	*14,454*
	Present Value of Minimum Lease Payments			***6,99,054***

2. Value of Machine to be recognized in the Books of Lessee

Amount recognized as Asset & Liability	=	*Fair Value of Asset at the date of inception of Lease = Rs.* ***7,00,000***	***OR***	*Present Value of Minimum Lease Payments (MLP) from the viewpoint of the Lessee = Rs.* ***6,99,054***	***whichever is Lower. Hence, Rs. 6,99,054***

3. Computation of Finance Charges (Lessee's Books)

Year	***Opening Balance***	***Finance Charges at 15% on Opg Bal.***	***Payment to Lessor***	***Balance Principal Repayment***	***Closing Balance***
(1)	***(2)***	***(3)***	***(4)***	***(5) = (4) – (3)***	***(6) = (2) – (5)***
1	*6,99,054*	*1,04,858*	*3,00,000*	*1,95,142*	*5,03,917*
2	*5,03,917*	*75,588*	*3,00,000*	*2,24,412*	*2,79,505*
3	*2,79,505*	*41,926*	*(incl. GRV) 3,22,000*	*2,79,505*	*(Rounded Off)* ***0***

Note: *The difference of Rs. 569 (Opening Balance Rs. 2,79,505 + Interest Rs. 41,926 - Lease Rental Rs. 3,00,000 - Guaranteed*

Residual Value Rs. 22,000) is due to rounding off.

Question 8

Annual Lease Rent = Rs. 40,000 at the end of each year Lease Period = 5 years Guaranteed Residual Value = Rs. 14,000 Fair Value at the inception (beginning) of Lease = Rs. 1,50,000

Interest Rate implicit in the lease is 12.6%. The Present Value Factors at 12.6% are 0.89,0.79,0.7,0.622,0.552 at the end of first, second, third, fourth and fifth year respectively.

Show the Journal Entry to record the Asset taken on Finance Lease in the books of the Lessee.

1. Present Value of Minimum Lease Payments from Lessee's viewpoint -

Year(s)	*Cash Flow Item*	*Amount*	*PV Factor*	*PV*
1-5	Annual Lease Rental (ALR)	6,25,000	0.89 + 0.79 + 0.70 + 0.622 + 0.522 = 3.555	1,42,200
5	Guaranteed Residual Value (GRV)	14,000	0.552	7,728
	Total			***1,49,888***

2. Value of Machine to be recognized in the Books of Lessee

Amount recognized as Asset & Liability	=	*Fair Value of Asset at the date of inception of Lease = Rs. **1,50,000***	***OR***	*Present Value of Minimum Lease Payments (MLP) from the viewpoint of the Lessee = Rs. **1,49,888***	***whichever is Lower. Hence, Rs. 1,49,888***

3. Journal Entry

S. No	*Particulars*	*Dr. (Rs.)*	*Cr. (Rs.)*
I	Asset A/c Dr.	1,49,888	
	To Lessor A/c		1,49,888
	(Being the asset taken on Finance Lease by the Lessee)		

Question 9

Ambika Ltd leased a Machinery to Bhanu Ltd on the following terms:

Fair Value of the Machinery	***Rs. 20.00 Lakhs***	***Guaranteed Residual value***	***Rs. 1.00 Lakhs***
Lease term	***5 years***	***Expected Residual Value***	***Rs. 2.00 Lakhs***
Lease Rental per annum	***Rs. 5.00 Lakhs***	***Internal Rate of Return***	***15%***

Depreciation is provided on Straight Line Method at 10% per annum. Ascertain Unearned Finance Income and necessary entries may be passed in the books of the Lessee in the first year.

1. Computation of Present Value of Minimum Lease Payments

Year(s)	*Cash Flow Item*	*Cash Flow*	*Discounting Factor*	*PV of Cash Flow*
1-5	Annual Lease Rental (ALR)	5,00,000	Annuity Factor at 15% for 5 years = 3.3522	16,76,100
5	Guaranteed Residual Value (GRV)	1,00,000	$\frac{1}{(1+0.15)^5}$ = 0.4972	49,720

	Present Value of Minimum Lease Payments from the view point of Lessee			***17,25,820***
5	*Unguaranteed Residual Value (URV)*	*1,00,000*	$\frac{1}{(1+0.15)^5}$ *= 0.4972*	*49,720*
	Present Value of Minimum Lease Payments from the view point of Lessor			***17,75,540***

2. Value of Machine to be recognized in the Books of Lessee

Amount recognized as Asset & Liability	=	*Fair Value of Asset at the date of inception of Lease = Rs.* ***20,00,000***	***OR***	*Present Value of Minimum Lease Payments (MLP) from the viewpoint of the Lessee = Rs.* ***17,25,820***	***whichever is Lower. Hence, Rs. 17,25,820***

3. Computation of Finance Charges (Lessee's Books)

Year	***Opening Balance***	***Finance Charges at 15% on Opg Bal.***	***Payment to Lessor***	***Balance Principal Repayment***	***Closing Balance***
(1)	***(2)***	***(3)***	***(4)***	***(5) = (4) – (3)***	***(6) = (2) – (5)***
1	*17,25,820*	*17,25,820 × 15% = 2,58,873*	*5,00,000*	*2,41,127*	*14,84,693*
2	*14,84,693*	*14,84,693 × 15% = 2,22,704*	*5,00,000*	*2,77,296*	*12,07,397*
3	*12,07,397*	*12,07,397 × 15% = 1,81,110*	*5,00,000*	*3,18,890*	*8,88,507*
4	*8,88,507*	*8,88,507 × 15% = 1,33,276*	*5,00,000*	*3,66,724*	*5,21,783*
5	*5,21,783*	*5,21,783 × 15% = 78,267*	*(incl GRV) 6,00,000*	*5,21,783*	*(Rounded Off)* ***0***
	Total	***8,74,230***	***26,00,000***	***17,25,820***	

Note: *The difference of Rs. 50 (Opening Balance Rs. 5,21,783 + Interest Rs. 78,267 - Lease Rental Rs. 5,00,000 - Guaranteed*

Residual Value Rs. 1,00,000) is due to rounding off.

4. Journal Entries in the Books of the Lessee

S.No.	***Particulars***	***Dr.(Rs.)***	***Cr.(Rs.)***
1	*Plant and Machinery A/c Dr.*	*17,25,820*	
	To Lease Payables A/c		*17,25,820*
	(Being Plant and Machinery purchased on Finance Lease recorded)		
2	*Interest Suspense A/c Dr.*	*8,74,230*	
	To Lease Payables A/c		*8,74,230*

	(Being Interest Portion of Lease Payments recognized as Payable)		
3	*Interest on Lease Payables A/c Dr.* *To Interest Suspense A/c* *(Being Interest Expense recognized for Year 1)*	*2,58,873*	 *2,58,873*
4	*Depreciation A/c Dr. (17,25,820 × 10%)* *To Plant and Machinery A/c* *(Being Depreciation for the year, at 10% on Cost of Asset)*	*1,72,582*	 *1,72,582*
5	*Profit and Loss A/c Dr.* *To Depreciation A/c* *To Interest on Lease Payables A/c* *(Being Interest and Depreciation for the period transferred to P8cL Account)*	*4,31,455*	 *1,72,582* *2,58,873*
6	*Lease Payables A/c Dr.* *To Bank A/c* *(Being Payment to Lessor for the year)*	*5,00,000*	 *5,00,000*

Note: *It is assumed that the Machinery is purchased at the beginning of the period.*

Question 10

Suraj Ltd wishes to obtain a Machine costing Rs. 30 Lakhs by way of lease. The effective life of the Machine is 14 years, but the Company requires it only for the first 5 years. It enters into an agreement with Ashok Ltd, for a lease rental for Rs. 3 Lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The Chief Accountant of Suraj Ltd is not sure about the treatment of these lease rentals and seeks your advise.

1. Useful Life of the Plant is 14 years whereas Lease Term = 5 years. Hence, it is an ***Operating Lease.***

2. As per Para 23, the Lease Payments in respect of an Operating Lease should be recognized as an Expense in the P & L Account of the Lessor. Hence Rs. 3 Lakhs should be debited to the P & L A/c.

Note: *The Implicit Rate of Interest 15% is* ***not*** *relevant for Expense Recognition in the Lessee's books. However, this rate 15% may be used to prove that the Present Value of Lease Payments for 8 years is not substantially equal to the Fair Value / Cost of the asset at the inception of the lease. Hence, it is confirmed that the Lease is an Operating Lease.*

Question 11

Angiras Ltd sold JOB Machine having WDV of Rs. 50 Lakhs to Brihaspati Ltd for Rs. 60 Lakhs and the same machine was leased back by Brihaspati Ltd to Angiras Ltd. The lease is an Operating Lease. Comment according to relevant AS, if -

(1) Sale Price of Rs. 60 Lakhs is equal to Fair Value.

(2) Fair Value is Rs. 50 Lakhs and Sale Price is Rs. 45 Lakhs.

(3) Fair Value is Rs. 55 Lakhs and Sale Price is Rs. 62 Lakhs.

(4) Fair Value is Rs. 45 Lakhs and Sale Price is Rs. 48 Lakhs.

Particulars	***Situation 1***	***Situation 2***	***Situation 3***	***Situation 4***
Fair Value at the time of Sale & Leaseback	*Rs. 60,00,000*	*Rs. 50,00,000*	*Rs. 55,00,000*	*Rs. 45,00,000*
Sale Proceeds	*Rs. 60,00,000*	*Rs. 45,00,000*	*Rs. 62,00,000*	*Rs. 48,00,000*
Carrying Amount of Asset	*Rs. 50,00,000*	*Rs. 50,00,000*	*Rs. 50,00,000*	*Rs. 45,00,000*
Application of Para 52 of AS-19	*Not Applicable*	*Not Applicable*	*Not Applicable*	*Impairment Loss = Rs. 5,00,000*
*Application of Para 50 **(Profit** or **Loss** is the difference between Sale Proceeds and Carrying Amount of Asset)*	*Profit= Rs. 10,00,000 recognised immediately.*	*Loss = Rs. 5,00,000 recognised immediately. **(See Note 1)***	*Profit = Rs. 5,00,000 recognised immediately. Balance Rs. 7,00,000 is deferred / amortised over lease period. **(See Note 3)***	*Profit = Rs. 3,00,000 deferred and amortised over period of use. **(See Note 2)***

Note:

*1. 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.*

2. Since Impairment Loss of Rs. 5,00,000 is recognized, the Revised Carrying Amount of the Asset will be Rs. 45,00,000 (by reducing the Carrying Amount to the Fair Value). Hence Profit will be Rs. 48,00,000 - Rs. 45,00,000 = Rs. 3,00,000.

*3. Profit being Fair Value Less Carrying Amount is recognized now. Balance Profit being Sale Proceeds **Less** Fair Value/ is deferred / amortised over lease period.*

Question 12

Ankit Ltd sold machinery having a WDV of Rs. 40 Lakhs to Balram Ltd for Rs. 50 Lakhs and the same machinery was leased back by Balram Ltd to Ankit Ltd. The Lease back is Operating Lease. Comment if-

(a) Sale Price of Rs. 50 Lakhs is equal to Fair Value.

(b) Fair Value is Rs. 60 Lakhs.

(c) Fair Value is Rs. 45 Lakhs and Sale Price is Rs.38 Lakhs.

(d) Fair Value is Rs. 40 Lakhs and Sale Price is Rs.50 Lakhs.

(e) Fair Value is Rs. 46 Lakhs and Sale Price is Rs.50 Lakhs.

(f) Fair Value is Rs. 35 Lakhs and Sale Price is Rs.39 Lakhs.

The accounting treatment in different situations in Achyut Ltd's books is summarized below -

(a) Profit of Rs.10 Lakhs (i.e. 50- 40) should be recognised immediately.

(b) Profit of Rs.10 Lakhs (i.e. 50- 40) should be recognised immediately.

(c) Loss of Rs. 2 Lakhs (40 - 38) should be immediately recognized, provided such loss is not compensated by future lease payment.

(d) Profit of Rs. 10 Lakhs should be deferred and amortized over the lease period.

(e) Profit of Rs. 6 Lakhs (46 - 40) should to be immediately recognized, and balance Profit of Rs. 4 Lakhs (50 - 46) should be amortised / deferred over lease period.

(f) Loss of Rs. 5 Lakhs (40 - 35) should be immediately recognized. Profit of Rs. 4 Lakhs (39 - 35) should be amortised / deferred over lease period.

AS-20: EARNING PER SHARE

CA. TEJAS SUCHAK
ACCOUNTANCY ACE

PRESENTATION OF BASIC AND DILUTED EPS

Both basic and diluted EPS should be presented on the face of statement of P&L with equal prominence for each class of equity shares.

CALCULATION OF BASIC EPS

$$= \frac{\text{Net profit /loss for the period attributable to Equity S.H.}}{\text{Weighted average no. of equity shares.}}$$

WHY WEIGHTED AVERAGE

- The figure of net profit/loss represents a period. However, no. of shares represents a figure at a point of time.
- To make the two figures compatible we consider the average no. of shares, which will represent the no. of shares over the period.

CALCULATION:

No. of ES o/s at the beginning of the period	X	Total duration of the period
Add: Shares issued	X	Duration for which they were issued
Less: Shares bought back	X	Duration o/s after buyback.

MORE THAN ONE CLASS OF EQUITY SHARES

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

DIVIDEND RIGHTS

- Amount/%age of dividend each class of ESH are entitled to.
- Net profit attributable to ESH will be divided between the different classes of shareholders in the ratio of dividend rights.

EQUITY SHARES ISSUED DURING AMALGAMATION

NATURE OF MERGER: The duration for the equity shares issued during merger should be from the beginning of the reporting period.

NATURE OF PURCHASE: The duration for the equity shares issued during purchase should be from the DATE OF ACQUISITION of the vendor company till the end of reporting period.

PARTLY PAID EQUITY SHARES

- Such equity shares are treated as a fraction of an equity share,
- to the extent they were entitled to participate in the dividends relative to fully paid equity shares.

EQUITY SHARES WITH DIFFERENT NOMINAL VALUES

If there are equity shares with different nominal values but same dividend rights, the number of equity shares will be calculated by converting all equity shares into equivalent number of equity shares having same nominal value.

AS-20: EARNING PER SHARE

CA. TEJAS SUCHAK
ACCOUNTANCY ACE

BONUS ISSUE/SHARE SPLIT/REVERSE SHARE SPLIT

The change in the no. of equity shares will be treated as if it had occurred from the beginning of the period.

BONUS ELEMENT IN RIGHT ISSUE (ADJUSTMENT FACTOR)

- In Right Issue, the exercise price of the shares is lower than the fair value of the shares.
- Hence the increase in proceeds is not proportionately equal to the increase in the no. of shares from right issue.
- This gives rise to a bonus element which is represented by the adjustment factor

RIGHT ISSUE

1.Calculate theoretical ex-right value/share=
(Aggregate Value of shares prior to right issue + proceed from right issue)/no. of shares outstanding after right issue.

2.Calculate adjustment factor=
Fair value before right issue/theoretical ex-right price.

3.Compute basic EPS
(This will be done by multiplying no. of shares prior to right issue by the adjustment factor.)

$$= \frac{\text{net profit attributable to ESH}}{\text{Old sh.*adj.fac*x/12 + new sh.*x/12}}$$

DILUTED EARNING PER SHARE

To calculate Diluted EPS,

– Net profit attributable to ESH &
– Weighted average no. of ES outstanding during the period

both should be adjusted for the effects of potential equity shares.

POTENTIAL EQUITY SHARES

Is a financial statement or other contract that entitles, or may entitle its holder to equity shares.
Example:

1.Debt instruments convertible to equity.
2.Preference Shares convertible to equity.
3. Share Warrants.
4. share Options.

TREATMENT OF NET PROFIT ATTRIBUTIBLE TO ESH(NUMERATOR)

-While calculating diluted EPS, the numerator will be increased by the amount of net cash outflow(interest/dividend) that will cease to be incurred if such potential ES are converted to ES.

NOTE: Potential ES should be considered as Dilutive when and only when their conversion to ES would result in decrease in Basic EPS. Otherwise, they are considered anti-dilutive.

TREATMENT OF WEIGHTED AVERAGE NO. OF ES(DENOMINATOR)

-While calculating diluted EPS, the denominator should be increased by the no. of shares that would have been outstanding, if the potential ES were converted to ES.
-The date from which such potential ES were held should be:

- Either, beginning of the year.
- Or, the date during the year, when such potential ES were issued.

Question 1:

Should Appropriation to Mandatory Reserves be excluded from Net Profit attributable to Equity Shareholders?

Kashyapa Ltd is engaged in manufacturing Industrial Packaging Equipment. As per the terms of an agreement entered into with its Debentureholders, the Company is required to appropriate adequate portion of its Profits to a Specific Reserve over the period of maturity of the Debentures such that, at the redemption date, the Reserve constitutes at least half the value of such Debentures. As such, appropriations are not available for distribution to the Equity Shareholders. Kashyapa Ltd has excluded this from the Numerator, in the computation of Basic EPS. Is this treatment correct?

*1. **AS - 20 Principle:** Para 11 states that "For the purpose of calculating Basic Earnings Per Share, the Net Profit or Loss for the period attributable to Equity Shareholders should be the Net Profit or Loss for the period after deducting Preference Dividends and any attributable Tax thereto for the period".*

*2. **Analysis:** With an emphasis on the phrase **"attributable to Equity Shareholders",** it may be construed that amounts appropriated to Mandatory Reserves as described in this case, though not available for distribution as dividend, are still attributable to Equity Shareholders.*

*3. **Conclusion:** So, the appropriation made to a Mandatory Reserve created for the redemption of Debentures would be included in the Net Profit attributable to Equity Shareholders for the computation of Basic EPS. The treatment given by the Company is **not correct.***

Question 2:

Ravi Ltd follows the calendar year for reporting purposes. During a year, it issued Rs. 80 Lakhs Equity Shares at par on 15th September. It had also bought back Rs. 20 Lakhs Equity Capital (at par) on 1st December. The Equity Capital was Rs. 150 Lakhs at the end of the year. Calculate the Weighted Average Number of Equity Shares outstanding during the period, if the price of each Share is Rs. 100. Compute Basic EPS if the Net Profit attributable to Equity Shareholders is Rs. 10 Lakhs.

***Opening Balance of Equity Capital:** The equation is Opening Capital + Fresh Issue - Buy Back = Closing Capital.*

*Hence, Opening Capital = Closing Capital + Buy Back - Fresh Issue = 150 + 20 - 80 = **Rs. 90 Lakhs.***

Computation of Weighted Average Number of Shares outstanding during the period

Date	***Equity Capital (in Rs. Lakhs)***	***No. of Equity Shares***	***Period Outstanding (upto 31st Dec.)***	***Time Weighting Factor***	***Weighted Average Number of Shares***
(1)	***(2)***	***(3) = (2) ÷ 100***	***(4)***	***(5)***	***(6) = (3) × (5)***
1st Jan	*90.00*	*90,000*	*12 months*	*12/12*	*90,000*
15th Sep	*80.00*	*80,000*	*3.5 months*	*3.5/12*	*23,333*
1st Dec	*20.00*	*(20,000)*	*1 month*	*1 /12*	*(1,667)*
Weighted Average Number of Equity Shares Outstanding during the period					***1,11,666***

Basic EPS** = $\frac{Net\ Profit\ or\ Loss\ attributable\ to\ Equity\ Shareholders}{Weighted\ Average\ Number\ of\ Equity\ Shares\ outstanding} = \frac{Rs.10,00,000}{1,11,666\ Shares}$ = **Rs. 8.96 per Share.

Alternatively/ *the Weighted Average Number of Equity Shares outstanding during the period may be calculated as -*

Period	***Period in Months***	***Time Weighting Factor***	***No. of Equity Shares***	***Weighted Average Number of Shares***
(1)	***(2)***	***(3)***	***(4)***	***(5) = (3) × (4)***
1st Jan to 15th Sep.	*8.5 months*	*8.5/12*	*Opening Balance = 90,000*	*63,750*
15th Sep to 1st Dec	*2.5 months*	*2.5 / 12*	*90,000 + 80,000 = 1,70,000*	*35,416*
1st Dec to 31st Dec	*1 month*	*1 / 12*	*1,70,000 - 20,000 = 1,50,000*	*12,500*
Weighted Average Number of Equity Shares Outstanding during the period				***1,11,666***

Question 3:

Compute Basic EPS for financial year ending 31st March from the following data:

1st April	***Equity Shares outstanding - Face Value Rs. 100 fully paid (Opening Balance)***	***10,000***
1st June	***Issue of Shares - Face value Rs. 100, Paid Up Amount Rs. 70***	***10,000***
1st July	***Buy-Back of Shares (fully paid)***	***4,000***
1st Nov	***Issue of Shares - Face Value Rs. 100 fully paid***	***6,000***
	Net Profit before Tax for the year (Tax Rate = 35%)	***Rs. 12 Lakhs***
	Preference Dividend (Dividend Distribution Tax = 12.5%)	***Rs. 5 Lakhs***

1. Computation of Weighted Average Number of Equity Shares Outstanding at end of the period

Date	***No. of Equity Shares***	***Proportion of Paid-up Value to FV***	***Period Outstanding (upto 31st Mar)***	***Time Weighting Factor***	***Weighted Average Number of Shares***
(1)	***(2)***	***(3)***	***(4)***	***(5)***	***(6) = (2) × (3) × (5)***
1st Apr	*10,000*	*Rs. 100 -h Rs. 100 = 100%*	*12 months*	*12/12*	*10,000*
1st Jun	*10,000*	*Rs. 70 -T Rs. 100 = 70%*	*10 months*	*10/12*	*5,833*
1st Jul	*4,000*	*Rs. 100 ÷ Rs. 100 = 100%*	*9 months*	*9/12*	*(3,000)*

1st Nov	6,000	Rs. 100 -T Rs. 100 = 100%	5 months	5/12	2,500
Weighted Average Number of Equity Shares Outstanding during the period					***15,333***

2. Net Profit attributable to Equity Shareholders

Particulars		***Rs.***
	Net Profit Before Tax	*12,00,000*
Less:	*Tax at 35%*	*(4,20,000)*
	Profit After Tax	*7,80,000*
Less:	*Preference Dividend + 12.5% Tax thereon*	*(5,62,500)*
	Net Profit for the period attributable to Equity Shareholders	***2,17,500***

3. Basic EPS $= \frac{\text{Net Profit or Loss attributab le to Equity Shareholde rs}}{\text{Weighted Average Number of Equity Shares outstandin g}} = \frac{\text{Rs.2,17,500}}{\text{15,333 Shares}}$ = ***Rs. 14.19 per Share.***

Question 4:

At the beginning of a financial year, a Company issued 1,20,000 Equity Shares of Rs. 100 each, Rs. 50 per Share was called up on that date which was paid by all Shareholders. The remaining Rs. 50 was called up on 1st September. All Shareholders paid the sum in September, except one Shareholder having 24,000 Shares. The Net Profit for the relevant financial year is Rs. 2,64,000 after dividend on Preference Shares and Dividend Distribution Tax of Rs. 64,000. Compute the Basic EPS for the year as per AS - 20.

Note: *It is assumed that Dividend is payable on Paid-Up Capital.*

1. Computation of Weighted Average! Number of Equity Shares outstanding at end of the period

Date	***No. of Equity Shares***	***Proportion of Paid- up Value to FV***	***Period Outstanding***	***Time Weighting Factor***	***Weighted Average No. of Shares***
(1)	***(2)***	***(3)***	***(4)***	***(5)***	***(6) = (2) × (3) × (5)***
1st Apr	*1,20,000*	*Rs. 50 ÷ Rs. 100 = 50%*	*5 months (upto 31st Aug)*	*5/12*	*25,000*
1st Sep	*96,000*	*Rs. 100 -f- Rs. 100 = 100%*	*7 months (upto 31st Mar)*	*7/12*	*56,000*
	24,000	*Rs. 50 ÷ Rs. 100 = 50%*	*7 months (upto 31st Mar)*	*7/12*	*7,000*
Weighted Average Number of Equity Shares Outstanding during the period					***88,000***

2. Basic EPS = $\frac{Net\ Profit\ or\ Loss\ attributab\ le\ to\ Equity\ Shareholde\ rs}{Weighted\ Average\ Number\ of\ Equity\ Shares\ outstandin\ g} = \frac{Rs.2,64,000}{88,000\ Shares}$ = ***Rs. 3.00 per Share.***

Question 5:

On 30th June 2016, Bhaskara Ltd merged into Aaroga Ltd. The amalgamation was accounted for in accordance with the "pooling of interest method" described in AS - 14. From the following relevant information for the year ended 31st March 2017, compute the EPS of Aaroga Ltd at the year-end, i.e. 31st March 2017.

Particulars	***Aaroga Limited***	***Bhaskara Limited***
Net Profit from date of Merger till year end	***Rs. 5,00,000***	***Rs. 2,00,000***
Net Profit earned until Merger	***Rs. 8,00,000***	
Number of Shares (Rs. 10 each)		
At the start of the year	***6,000***	***4,000***
On date of merger	***6,000***	***4,000***
At year end (31st March)	***10,000***	

1. Total Profits for the year for the Combined Enterprise, as if it had existed from the beginning of the year = Rs. 5,00,000 + Rs. 8,00,000 + Rs. 2,00,000 =	*Rs. 15,00,000*
2. Weighted Average Number of Shares for the Combined Enterprise	*10,000 Shares*
3. Basic EPS for Aaroga Ltd for the year ended 31st March = 1 2	***Rs. 150 per Share***

Question 6:

During the year ended 31st March 2018, Jayabhadra Ltd makes a public issue of 100,000 Equity Shares of Rs. 10 each. The issue was fully subscribed and the calls were made as -

- ***Rs. 5 on application and allotment made on 1st July 2017***
- ***Rs. 2 on First Call made on 30th September 2017***
- ***Rs. 3 on Second and Final Call made on 1st January 2018***

Partly Paid Shares are entitled to participate in the dividend to the extent of amount paid. The Company had 5,00,000 Shares outstanding at the beginning of the year and, apart from the Public Issue of Shares made above, there were no other additions to or reductions from Share Capital. Calculate the Weighted Average Number of Equity Shares for computation of Basic EPS.

Number of Shares	***Time Weighting Factor***	***Paid-up Value Equivalent for Rs. 10 per Share***	***Weighted Average Number of Equity Shares***

(1)	(2)	(3)	(4) = (1) × (2) × (3)
Opg Bal: 5,00,000	*12/ 12*	*10/ 10 = 1.00*	*5,00,000*
Application: 1,00,000	*(from 1st July) 9/12*	*5 / 10 = 0.50*	*37,500*
I Call: 1,00,000	*(from 30th Sep) 6 / 12*	*2 / 10 = 0.20*	*10,000*
II Call: 1,00,000	*(from 1st Jan) 3/12*	*3 / 10 = 0.30*	*7,500*
Weighted Average Number of Equity Shares Outstanding during the period			***5,55,000***

Question 7:

The following information is available for Savita Ltd for the Accounting year 2016-2017 and 2017-2018:

Net Profit for Year 2016-2017 ***Net Profit for Year 2017-2018***	***Rs. 22,00,000*** ***Rs. 30,00,000***	***Right Issue: One Share for each five Shares Outstanding, i.e. 2,00,000 Shares***
No of Shares Outstanding prior to Right Issue	***10,00,000***	***Right Issue Price Rs. 25***
Fair Value of one Share immediately prior to exercise of right	***Rs. 32***	***Last date to exercise right 31.07.2015***

You are required to compute -

(a) Basic Earnings per Share for the year 2016-2017.

(b) Re-stated Basic Earnings per Share for the year 2016-2017 for Right Issue.

(c) Basic Earnings per Share for the year 2017-2018.

	Computation	Result
1	***Determination of Theoretical Ex-Rights Fair Value / Price:*** $\frac{(Base\ Shares\ Quantity \times\ Fair\ Value\ per\ Share\ Before\ Rights)\ +\ (Rights\ Issue\ \times\ Rights\ Issue\ Pri}{Base\ Shares\ Quantity\ +\ Rights\ Shares\ Quantity}$ $= \left[\frac{(10,00,000 \times Rs.32) + (2,00,000 \times Rs.25)}{10,00,000 + 2,00,000}\right]$	*Rs. 30.83*
2	*Adjustment Factor (AF)* $= \frac{Fair\ Value\ before\ Rights\ Issue}{Theoretica\ 1\ Ex - Rights\ Price\ (as\ per\ Stage\ 1)} = \frac{Rs.32}{Rs.30.83}$	*1.04*
3	*Weighted Average Number of Shares (WANES) Outstanding during the period* ***(Note)***	*11,46,667*

		Shares
4	*Basic EPS for Current Year* = $\frac{Equity\ Earnings}{WANES\ as\ per\ Stage\ 3} = \frac{Rs.30,00,000}{1,46,447\ Shares}$	**Rs. 2.62**
5	*Basic EPS for Previous Year as originally reported* = $\frac{Previous\ Year's\ Equity\ Earnings}{Previous\ Year's\ WANES} = \frac{Rs.22,00,000}{10,00,000}$	**Rs. 2.20**
6	*Adjusted Basic EPS for Previous Year* = $\frac{PY\ Equity\ Earnings}{(PY\ Wanes \times AF)} = \frac{Rs.22,00,000}{(10,00,000 \times 1.04)}$	**Rs. 2.12**

Note: Computation of Weighted Average Number of Equity Shares Outstanding for the current year

Period	***Period*** *(in mths)*	***Time Weighting Factor***	***Adjustment Factor***	***No. of Equity Shares***	***Weighted Average Number of Shares***
(1)	***(2)***	***(3)***	***(4)***	***(5)***	***(6) = (3) × (4) × (5)***
1st Apr to 31st Jul	*4*	*4/12*	*1.04*	*10,00,000*	*3,46,667*
1st Aug to 31st Mar	*8*	*8/12*	*NA*	*12,00,000*	*8,00,000*
Weighted Average Number of Shares outstanding during the period					***11,46,667***

Note: This method is prescribed in the Institutes study material. Students are advised to follow the method that is discussed in the class.

Question 8:

"While calculating Diluted Earnings Per Share, effect is given to all dilutive Potential Equity Shares that were outstanding during that period." Explain. Also calculate the Diluted Earnings per Share from the following information:

Net Profit for the Current Year	***Rs. 85,50,000***
No. of Equity Shares Outstanding	***20,00,000***
No. of 8% Convertible Debentures of Rs. 100 each (Each Debenture is convertible into 10 Equity Shares)	***1,00,000***
Interest Expenses for the current year	***Rs. 6,00,000***
Tax relating to Interest Expenses	***30%***

Particulars	***For Basic EPS***	***Adjustment for Dilution***	***For Adjusted EPS***
(1)	***(2)***	***(3)***	***(4) = (2) + (3)***

1. Net Profit for the period attributable to Equity Shareholders	*Given Rs. 85,50,000*	***(Note 1)*** *Rs. 4,20,000*	*Rs. 89,70,000*
2. Weighted Avg No. of Equity Shares	*Given 20,00,000*	$1,00,000 \times 10 \times \frac{9}{12} =$ *7,50,000*	*27,50,000*
3. EPS =1 ÷ 2	*Basic EPS = Rs.* ***4.275***		*Diluted EPS = Rs.* ***3.26***

Note:

1. Tax Adjusted Interest on 8% Convertible Debentures = Interest as given × (100% - Tax Rate)

= Rs. 6,00,000 × (100% - 30%) = Rs. 4,20,000.

2. Annual Interest on Debentures = 8% × Rs. 100 × 1,00,000 Debentures = Rs. 8,00,000. However, Interest Expense for the current year is given as Rs. 6,00,000. Hence, it implies that Debentures are issued during the year. ***Period*** *=* ***9 Months,*** *by comparing Annual Interest at 8% Rs. 8,00,000, with the given Interest Expense of Rs. 6,00,000.*

AS-22: ACCOUNTING FOR TAXES ON INCOME

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ACCOUNTANCY ACE

SCOPE

-This standard is applied to taxes on income (income tax).
-This includes all domestic & foreign taxes which are based on taxable income.
-Not applicable on dividend distribution tax.

DEFINITIONS

ACCOUNTING INCOME

Accounting income is the net profit/loss before tax for the period as per the statement of P&L.

TAXABLE INCOME

Taxable Income is the income/loss as determined by the income tax laws.

CURRENT TAX

Current tax is the amount of income tax payable/recoverable for a period (tax liability as per income tax laws).

DEFERRED TAX

Deferred tax is the tax effect of timing differences.

TAX EXPENSE

Tax expense is the total of current tax and deferred tax charged or credited to P&L.

REASONS FOR DIFFRENCE BETWEEN ACCOUNTING INCOME AND TAXABLE INCOME

TIMING DIFFERENCE

-It is the difference that arises in one period and is capable of being reversed in one or more subsequent periods.

-DTA/DTL should be created for all timing differences in the year in which difference arises and should be reversed in the subsequent years when the difference is rectified.

Eg:1. Depreciation as per accounts & as per tax records.

2.Expenses as per accounts- recognised as & when accrues.
Expense as per sec 43B- when paid.

PERMANENT DIFFERENCE

-Differences that arise in one period and are do not reverse subsequently.

-No DTA/DTL will be recognised for permanent differences.

-These items are incomes or expenses either for accounting or tax purposes.

Eg: dividend income.

Expenses disallowed u/s 40A.

Agricultural income.

Donation not covered u/s 80G.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

RECOGNITION

DEFERRED TAX ASSET

Deferred tax asset should be recognised in the books, when taxes of initial years are higher and subsequent years are lower.

This means deferred tax should be recognised when entity is going to receive tax benefit in the future years.

-Assets should be recognised only when future economic benefits are probable i.e. chances >50%.

-Hence, DTA should be recognised & carried forward only to the extent that there is a REASONABLE CERTAINITY that sufficient future taxable income will be available against which such DTA can be realised.

-Reasonable certainty can be ascertained based on:-

Past trends of incomes & business, management estimates of future profits, credit rating, industrial development, lucrative contracts in hand.

UNABSORBED DEPRECIATION & CARRY FORWARD OF LOSSES

-DTA with respect to unabsorbed depreciation & carry forward of losses can be created only when there is VIRTUAL CERTAINITY supported by CONVINCING EVIDENCE that sufficient future taxable income will be available against which such DTA can be recognised.

CONVINCING EVIDENCE

When there is concrete proof, an entity will be said to have convincing evidence.
Eg; profitable binding export order, cancellation of which my result in payment of heavy damages by the defaulting party.

DEFERRED TAX LIABILITY

Deferred tax liability is recognised without analysing any certainty level.

RE-ASSESSMENT OF DTA

On every balance sheet date an entity should reassess DTA.

If there is improvement in subsequent years regarding reasonable/virtual certainty that sufficient future taxable income will be available against which such DTA can be recognised, the entity should recognise the unrecognised DTA in that year.

The entity should write down the carrying amount of a DTA to the extent there is no longer reasonable/virtual certainty that sufficient future taxable income will be available against which DTA can be realised and vice versa.

MEASUREMENT

CURRENT TAX

Will be measured using applicable tax rates and tax laws.

DEFERRED TAX

Will be measured using substantively enacted tax rates and tax laws.

SUBSTANTIVELY ENACTED:- tax rates 7 laws of the year in which the benefit of DTA will arise or the obligation of DTL will be settled.

TAX HOLIDAY (U/S 80-IA, 80-IB, 10A & 10B of the INCOME TAX ACT, 1961)

-Deferred tax in respect of timing differences arising and reversing during the tax holiday period should not be recognised as these timing differences do not satisfy the definition of asset or liability.

-Deferred tax in respect of timing differences arising during the tax holiday period and reversing after the tax holiday period should be recognised in the period in which difference is arising.

NOTE: for the above purposes the timing differences which originate first are considered to reverse first.

PRESENTATION & DISCLOSURE

An entity should set off assets (advance tax paid) and liabilities (provision for tax) representing current tax and also DTA & DTL if the entity:

1. Has a legally enforceable right to set off the recognised amounts.
2. Intends to settle the asset and the liability on a net basis.

LEGALLY ENFORCIABLE RIGHT: An entity is set to have a legally enforceable right to set off when the asset & the liability relate to income taxes levied under the same governing taxation laws and the tax law permit the entity to make or receive a single net payment.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

Question 1

What is the treatment of exemptions, deferments, rebates allowed under GST as per AS 22?

Answer

AS 22 is applicable for income taxes but not on indirect taxes like GST. There is NO need to create deferred tax on these items.

Question 2

Yogita Ltd. holds 5,000 shares of Pavan Ltd. acquired at a cost ofRs.12.85 lakh. During the current year, the market value of the shares is Rs.10 lakh. The fall in the value of share is considered permanent by the analysts as well as the company, hence the company reduced its value of the long-term investments at Rs.10 lakh as on balance sheet date. The loss of Rs.2.85 lakh is charged to P&L as per AS 13. The company has considered the permanent fall in the value of investments as permanent difference, since such fall in the value cannot be claimed as a deduction in determining the tax payable. Do you agree with this?

Answer

As per AS 22, permanent difference means difference between accounting income and income under income-tax laws, which arises in one accounting period and do NOT reverse subsequently.

In the given case, the loss arising from permanent diminution in value of investments is capable of being reversed when the investments are sold i.e. such fall will be considered as a deduction in the year of sale. Hence it is NOT a permanent difference. The intention of the company is NOT correct and they should treat it as timing difference and create deferred tax asset accordingly.

Question 3

Mayur Ltd. is into growing and manufacturing tea business. As per the Income-tax Act, if the entity deposits any amount in a specific reserve account, it will be allowed as a deduction in the year of deposit. But when it is not used for the specific purposes, it will be taxable in that year. Do they need to recognise any deferred tax on this amount of reserve?

Answer

In the given case, the entity is getting the deduction in the year of deposit hence its taxable income is lower than the accounting income. As per the Standard, timing difference is the difference arises in one period and is capable of being reversed in one or more subsequent periods.

In this case, the deduction of contribution to specific reserve is possible of being reversed in the subsequent periods. Hence the entity should recognise DTL for this.

Question 4

Aradhya Ltd. sold a long-term machine and made a capital loss as per the Income-tax Act, 1961. As per the provisions of the Act, the capital loss can be carried forwarded and offset in the future years, only against the income under the head 'Capital gains'. Can the company recognise deferred tax asset for the capital losses?

Answer

As per AS 22, DTA should be recognised and carried forwarded subject to consideration of prudence and in case of DTA with respect to loss can be recognised only when there is a virtual certainty, supported by convincing evidence that sufficient future taxable income will be available under the head 'capital gains' so that the loss can be set-off.

In the given case, the company can recognise DTA only when it proves that they are going to sell some capital asset (based on binding sale agreement) which gives capital gain and can get the benefit of set off. If the entity sold any capital asset after the balance sheet date and before the approval of financial statements (events occurring after the balance sheet date) and got a capital gain which will be sufficient to set off the capital losses, the entity can create DTA to that extent. If the entity is not able to provide evidence before approval of financial statements by its Board of Directors, it cannot recognise DTA in the current year. The entity should disclose the nature of the supporting evidence in the notes on accounts.

Question 5 *(CA Final Nov 2002 & 2004 - Audit)*

As a Statutory Auditor for the year ended 31 st March, 2016, how would you deal with the following: Preksha Ltd., a listed co., was incurring heavy losses since the last several years and the industry in which it was functioning was not expected to perform better in the next few years. While finalizing the accounts for the year ended 31st March, 2016, the CFO of the co., decided to create a Deferred Tax Asset for the tax benefits that would arise in future years from the earlier years' losses that had remained unabsorbed in Income tax.

Answer

As per AS 22, DTA should be recognised for all timing differences subject to consideration of prudence. Recognition of DTA with respect to unabsorbed depreciation and carry forward losses requires virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such DTA can be realised.

In the given case, the industry in which Preksha Ltd. is functioning is not expected to perform better in the next few years. Thus, the required virtual certainty is missing here. As per the AS 22, DTA should not be recognised in this case.

In view of the above, as a statutory auditor, we will qualify our report stating that DTA has been created by the company though there is no virtual certainty for getting the said benefit in income-tax. The amount by which loss for the years has been understated and the amount by which reserve have been consequently overstated will also be mentioned in the audit report.

Question 6

Rama Ltd., has provided the following information:

Depreciation as per accounting records = Rs.2,00,000 Depreciation as per income-tax records = Rs.5,00,000 Unamortized preliminary expenses as per tax record = Rs.30,000

There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment? Tax rate 50%. *(CA Inter - May 2018)*

Answer

As per AS 22, Deferred tax should be recognised for all timing differences and NO deferred tax should be recognised for permanent differences. Deferred tax should be measured using the applicable tax rates.

In the given case, difference in depreciation and preliminary expenses are capable of being reversed in the future years; hence these are timing differences and the entity should recognise deferred tax for these items. Point no. 1

Depreciation expense as per income-tax records is higher than accounting records, it means the entity is getting the tax benefit on depreciation early - (Expense as per accounting records is LOWER than income- tax records - Recognise DTL). Recognise DTL to that extent of Rs.3,00,000

(i.e. X5 lakh - 2 lakh)

Point no. 2

Preliminary expense as per income-tax records is lower than accounting records (as it is not yet amortised fully) i.e. tax benefit on this expense is postponed and the tax benefit is available in the future, hence recognise DTA to that extent of Rs.30,000.

Hence NET DTL to be recognised for Rs.1,35,000 i.e. (Rs.3,00,000 - Rs.30,000) x 50% (when DTA & DTL are arising from same governing tax laws - we will have legal enforceability to set off)

Question 7

Omega Limited is working on different projects which are likely to be completed within 3 years' period. It recognizes revenue from these contracts on percentage of completion method for financial statements during 2006, 2007 and 2008 for Rs.11,00,000, Rs. 16,00,000 and X21,00,000 respectively. However, for income-tax purpose, it has adopted the completed contract method under which it has recognized revenue of Rs.7,00,000, Rs.18,00,000 and Rs.23,00,000 for the years 2006, 2007 and 2008 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 2006, 2007 and 2008.

Answer

As per AS 22, Deferred tax should be recognised for all timing differences and NO deferred tax should be recognised for permanent differences.

In the given case, the method of computing revenue is different from accounting books to income-tax books. The total revenue should be recognised over the three years' period under both the books of account; hence this is a timing difference and deferred tax should be recognised accordingly in the books.

Total income under the books of account = Rs.11 lakh + Rs.16 lakh + X21 lakh = Rs.48 lakh.

Total income under the books of income-tax = XI lakh + ?! 8 lakh + X23 lakh = Rs.48 lakh.

First year :

The entity recognised X4 lakh less income (Rs. 11 lakh - XI lakh) as per tax books and postponed the tax liability of Rs.1,40,000 (i.e. XA lakh x 35%) to the future years. Hence the entity should recognise DTL to this extent.

Second year:

The cumulative difference of income is reduced to X2 lakh [(Rs.11 lakh + Rs.16 lakh) - (XI lakh + Rs.18 lakh), hence the DTL should be reduced to Rs.70,000 (X2 lakh x 35%). (Reverse the DTL to the extent of Rs.70,000)

Third year:

There is no difference of income, hence the PY balance of DTL of Rs.70,000 should be reversed in the CY and the balance of DTL at the end of the third year is NIL.

Question 8

Company A has a block of assets with a written down value of Rs. 1,00,000 on April 1, 2016 for tax purposes. The book value of the assets for accounting purposes is also Rs. 1,00,000. The assets are depreciated on written down value basis at 25 per cent per annum for both accounting and tax purposes. Of the entire block, assets costing Rs.5,000 on April 1, 2016, were sold for Rs. 10,000 on March 31, 2018. Compute the deferred tax asset/liability assuming tax rate of 40 per cent. (CA Final RTP- Nov 2013)

Answer

Depreciation for income-tax purposes is computed on block of assets, rather than for individual assets. Further, as per section 50 of the Income-tax Act, 1961, the entire sale consideration received on sale of fixed assets should be reduced from the written down value of the relevant block.

For example, if the block had a written down value of Rs.10,000 and an asset costing Rs.2,000 was sold for Rs.3,000, the block would be reduced by Rs.3,000 rather than by Rs.2,000. Conversely, if the asset had been sold for %1,000 the block would have been reduced by Rs.1,000 and not by Rs.2,000.

The difference in depreciation will be reversed in the future years - hence it is a timing difference and deferred tax should be recognised for this. Let us look for year wise requirement of deferred tax;

FY 2016-17: Depreciation for both accounting and taxation purposes would be Rs.25,000 (25 per cent of Rs. 1,00,000). Accordingly no timing difference arises on this account.

FY 2017-18: Depreciation for the year would be Rs. 18,750 (Rs.75,000 x 25%) as per the books of account, while for tax purposes it would be Rs.16,250 [(Rs.75,000 -Rs.10,000) x 25%] as sale proceeds of Rs.10,000 would be reduced from the block of assets prior to the computation of depreciation. Accordingly, the following timing differences arise:

(a) Timing difference of depreciation is Rs.2,500 (i.e. 18,750 - Rs.16,250); (Excess expense)

(b) Accounting books recognise profit on sale of fixed asset and where as there is NO such profit as per tax purpose. Hence this timing difference also should be recognised. (Excess income)

Sale proceeds of fixed asset	*Rs. 10,000*
Accounting book value as on 31st March, 2018 (Rs.5,000-?l,250-Rs.938)	*72,812*
Profit on sale of asset	*Rs.7,188*

The net timing difference would be Rs.4,688 (Rs.7,188 - Rs.2,500), by which the accounting income would exceed the taxable income, thus requiring creation of a deferred tax liability of Rs.1,875 (Rs.4,688 x 0.4).

Question 9

A company, ABC Ltd., prepares its accounts annually on 31st March. On 1st April, 2016, it purchases a machine at a cost of Rs. 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight-line method is considered appropriate for accounting purposes. Substantively enacted tax rates for 2016, 2017 and 2018 are 40%, 35% and 38% respectively. Compute the amount of deferred tax for the three years.

Answer

As per AS 22, deferred taxes should be recognised for all the timing differences and these should be measured using the applicable tax rates and tax laws that have been enacted OR substantively enacted

as on the balance sheet date.

In the given case, the entity has got 100% tax benefit on depreciation in the first year itself (early *benefit); hence accounting income is higher than the taxable income. This situation rises deferred tax liability. In the given situation, balance sheet approach will be better approach to understand. Try to read slowly.*

Particulars	*Year 2016*	*Year 2017*	*Year 2018*
Carrying amount as per Accounting *As per Tax books*	*1,00,000* *0*	*50,000* *-*	*-* *-*
Timing difference	*(1,00,000)*	*+ 50,000*	*0*
	Originated in this year	*Reversed to the extent of Rs.50,000*	*Completely reversed*
Substantially enacted rates	*40%*	*35%*	*38%*
Deferred tax liability at the end of each balance sheet date	*40,000* *(1,00,000x 40%)*	*17,500* *(50,000 x 35%)*	*0*
Amount debited/(credited) to P&L	*40,000*	*(22,500)* *The balance of DTL should be Rs. 17,500, hence*	*(17,500)* *The balance of DTL should be Rs. Nil, hence reverse*
		reverse Rs. 22,500 in CY	*Rs. 17,500 in CY*

Question 10

The income before depreciation and tax of an entity for 15 years is Rs.1,000 lakh per year, both as per the books of account and for income-tax purposes. The entity is subject to 100% tax holiday for the first 10 years under section 80-IA. Tax rate is assumed to be 30%. At the beginning of year 1, the entity has purchased one machine for 1500 lakh. Residual value is assumed to be nil. For accounting purposes, the entity follows straight-line method of depreciation. For tax purposes, the depreciation rate relevant to the machine is 25% on written down value basis. Compute deferred tax for all 15 years.

Answer', *[go through the above wordings once again before looking into the Answer) Let us compute depreciation and yearly timing differences*

Year	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*	*15*	*15*
Accounting depreciation	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*100*	*-*
Tax	*375*	*281*	*211*	*158*	*119*	*89*	*67*	*50*	*38*	*28*	*21*	*16*	*12*	*9*	*7*	*19*

depreciation																
Timing difference	Rs.275	181	111	58	19	11	-33	-50	-62	-72	y-79	-84	-88	-91	-93	19
	644					228										

Timing ditterences originating during the tax holiday period are <644 lakh, out ot which <228 lakh are reversing during the tax holiday period and Rs.416 lakh are reversing after the tax holiday period.

Carrying amount of asset after 15 years - as per books of account = Rs.Nil; as per tax books = Rs.19 lakh;

Timing difference of Rs.19 lakh is originating in the 15th year which would reverse in subsequent years when for accounting purposes depreciation would be nil but for tax purposes the written down value of the machinery of Rs.19 lakh would be eligible to be allowed as depreciation.

As per the Standard, deferred tax on timing differences which reverse during the tax holiday period should not be recognised. For this purpose, timing differences which originate first are considered to reverse first. Therefore, the reversal of timing difference of Rs.228 lakh during the tax holiday period, would be considered to be out of the timing difference which originated in year 1 i.e. Rs.275. The remaining timing

difference originating in year 1 Rs.47 lakh (Rs.275 lakh - Rs.228 lakh) and timing differences originating in years 2 to 5 would be considered to be reversing after the tax holiday period i.e. from 11th year onwards. Therefore, deferred tax would be recognised on the timing difference of Rs.47 lakh which would reverse after the tax holiday period. Similar computations would be made for the subsequent years. The deferred tax assets/liabilities to be recognised during different years would be computed as per the following Table:

Year	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Timing difference which will be reversed after tax holiday	47	181	111	58	19	0	0	0	0	0	79	84	88	91	74
Deferred tax @ 30%	-14	-54	-33	-17	-6	0	0	0	0	0	24	25	26	27	22

Question 11

Y Ltd. is a full tax free entity for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference resulting in a tax liability in year 1 and 2 is Rs.200 lakh and Rs.400 lakh respectively. From the third year it is expected that the timing difference would reverse each year by Rs.10 lakh. Assuming tax rate of 35%, find out the deferred tax liability at the end of the second year and any charge to the Profit and Loss account.(CA Final Nov 2012, May 2010 & 2006)

Answer

As per AS 22, in the case of tax free companies, no DTA/DTL is recognized, in respect of timing differences that originate and reverse in the tax holiday period. DTA/DTL is created in respect of *timing differences that originate in a tax holiday period but are expected to reverse after the tax holiday period. For this purpose, adjustments are done in accordance with the FIFO method.*

In the given case, out of Rs.200 lakh of timing difference in the first year, only Rs.80 lakh will be reversed during the tax holiday period (to the extent of Rs.80 lakh, NO DTA/DTL). Therefore, first year DTL will be created on Rs.120 lakh @ 35% (i.e.) Rs.42 lakh. In the second year, the entire Rs.400 lakh will reverse only after the tax holiday period; hence the entity needs to recognise additional Rs.140 lakh DTL (Rs.400 x 35%). Total DTL at the end of second year would be Rs. 182 lakh (Rs.42 lakh + Rs. 140).

Therefore, deferred tax charge in the second year Profit and Loss Account will be Rs.400 x 35% = 140 lakh. Students are expected to have knowledge about Minimum Alternative Tax (MAT);

Question 12

Yogita Ltd. has DTL of Rs.1 lakh and this may be reversed at the end of 3rd year; As it may be payable or reversible at the end of the 3rd year, the chief accountant of the company wants to recognise present value (discounting) of Rs.1 lakh in the CY. Is this permitted in AS 22?

Answer

As per AS 22, Deferred tax assets and liabilities should not be discounted to their present value. In general, reliable determination of detailed scheduling of the timing of the reversal of each timing difference is impracticable or highly complex. Therefore, it is inappropriate to recognise at present value; hence, this Standard does not require or permit the discounting of deferred tax assets and liabilities.

Considering the above, the chief accountant's view is NOT correct.

Question 13

The following details are available in the books of Gangotri Ltd.

Particulars	*Year*	*Rs.in lakh*
Provision for tax:		
	For 2016-17	*200*
	For 2017-18	*300*
	For 2018-19	*250*
Advance tax paid:		
	For 2016-17	*175*
	For 2017-18	*350*
	For 2018-19	*270*

Gangotri Ltd. estimates its DTL to be Rs.100 lakh and its DTA to be Rs.20 lakh. How will the above be disclosed? *(CA Final R TP- Nov 2005)*

Answer

As per AS 22, an entity should set off assets (advance tax paid) and liabilities (provision for tax) representing current tax if the entity has a legally enforceable right to set off the recognized amounts and intends to do settle them on a net basis and Deferred tax asset and deferred tax liability can be set off when they are arising from the same governing laws.

Applying these principles in the given case, the required disclosures will be as follows:

Balance sheet of Gangotri *(Rs. in lakh)*

Liabilities	*Amount*		*Assets*	*Amount*	
Non-current liabilities			*Current assets*		
			loans and advances		
Deferred tax liabilities	*100*		*Advance tax paid*	*795*	
Less: Deferred tax assets	*20*	*80*	*Less: Provisions*	*750*	*45*

Question 14

Radha Ltd. is a multi-national company with many subsidiaries all over the world. The accountant Mr. Krishna has a question regarding set off deferred taxes while preparing consolidated financial statements as on 31-03-2017. The holding company has recognised DTA of Rs.250 crore and all other foreign subsidiaries have DTL together Rs.140 crore. His question is whether the entity can off-set the DTL of foreign subsidiaries with its DTA of Indian holding company. Help him.

Answer

As per AS 22, an entity can set off DTA and DTL when both are levied by the same governing laws and it has a legal enforceable right to set off.

In the given case, DTA of holding company is arising from the Indian Income-tax Act and where as the DTL of foreign subsidiaries are from different foreign laws. As the governing tax laws are different, the entity will not have legal enforceability to set off the DTA & DTL. Considering this, the entity cannot set off DTA and DTL. It should disclose DTA & DTL separately in its balance sheet as on 31-03-2017.

The break-up of DTA and DTL into major components of the respective balances should be disclosed in the notes on accounts. The nature of the evidence supporting the recognition of DTA should be disclosed, if an entity has unabsorbed depreciation or carry forward of losses under tax laws.

AS-24: DISCONTINUING OPERATIONS

CA TEJAS SUCHAK
ACCOUNTANCY ACE

DISCONTINUING OPERATION is a component of the entity which

1. Represents;
   - Separate major line of business
     OR
   - Geographical area of operations.

2. Can be distinguished for;
   - Operational purpose
     AND
   - Financial reporting purpose.

3. Is discontinued as per a SINGLE PLAN by

Selling SUBSTANTIALLY IN TOTAL Either in
- Single transaction
- Demerger
- spinoff

Selling off components assets

INDIVIDUALLY (piecemeal disposal)

And settling its liabilities also individually.

Termination through ABANDONEMENT. (Stopping with an intention to sell later on.)

WHEN IS AN OPERATION CONSIDERED A COMPONENT

An operation which is a component
- which is either a major line of business. OR
- Which is a business in a particular geographical area.

WHEN IS A COMPONENT CONSIDERED DISTINGUISHABLE FOR OPERATIONAL & FINANCIAL REPORTING PURPOSES

When the operations Assets & Liabilities can be directly attributed to it.

Its revenue can be directly attributed to it.

A majority of its expenses can be directly attributed to it.

IMPORTANT POINT: DISCONTINUING OPERATIONS VS DISCONTINUING PRODUCT LINE

If an entity discontinues a product line, it will not be considered a discontinuing operation and hence no disclosure is required under this standard. (Eg: TATA discontinuing NANO)

INITIAL DISCLOSURE EVENT

Entity should disclose discontinuing operation from earlier of the following:

- Entered into a binding sale agreement for substantially all of the assets of the discontinuing operation.

OR

- Board of Directors/similar governing body has;
  - Approved a detailed, formal plan for discontinuance. AND
  - Made an announcement of the formal plan for discontinuance.

INFORMATION TO BE DISCLOSED

- Identification of major assets to be disposed off.
- Expected method of disposal
- Expected period to complete the disposal
- Principal locations affected.
- Location, function & approximate number of employees who will be compensated for terminating their services.
- Estimated amount to be realised by disposal.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

Question 1

Q Ltd is in the business of manufacture of Passenger Cars and Commercial Vehicles. The Company is working on a strategic plan to shift from the Passenger Car segment over the coming 5 years. However, no specific plans have been drawn up for sale of neither the Division nor its Assets. As part of its plan, it will reduce the production of Passenger Cars by 20% annually. It also plans to commence another New Factory for the manufacture of Commercial Vehicles and transfer surplus employees in a phased manner.

(a) You are required of comment if mere gradual phasing out in itself can be considered as a "Discontinuing Operation' within the meaning of AS-24.

(b) If the Company passes a Resolution to sell some of the assets in the Passenger Car Division and also to transfer few other Assets of the Passenger Car Division to the factory, does this trigger the application of AS-24?

(c) Would your answer to the above be different, if the Company resolves to sell the assets of the Passenger Car Division in a phased but time bound manner?

Conclusion:

1. Mere gradual phasing out in itself cannot be considered as Discontinuing Operation.

2. Passing of Resolution to sell some of the assets in the Passenger Car Division and also to transfer few other Assets of the Passenger Car Division to the factory, does not trigger the application of AS-24.

3. Resolution to sell assets of the Passenger Car Division in a phased but time bound manner will lead to identification of a Discontinuing Operation as per AS-24.

Question 2

A Company belonging to the process industry carries out three consecutive processes. The output of the 1st Process is taken as input of the 2nd Process, and the output of the 2nd Process is taken as input of the 3rd Process. The final product emerges out of the 3rd Process. It is also possible to outsource the intermediate products, it has been found that over a period of time cost of production of the 1st Process is 10% higher than the Market Price of the Intermediate Product available freely in the market. The Company has decided to close down the 1st Process as a measure of cost saving (vertical spin-off) and outsource. Should this event be treated as Discontinuing Operation?

Conclusion: *The change given above does **not** meet the definition criteria of AS - 24 namely, disposing of substantially in its **entirety,** such as by selling a component of the Enterprise in a single transaction. The change is merely a cost-saving endeavour. Hence, this change over is **not** a Discontinuing Operation.*

Question 3

A Healthcare Goods Producer has changed the product line during a year as follows -

	Washing Soap	***Bathing Soap***
1st Quarter and 2nd Quarter, per month	***2,00,000***	***2,00,000***
3rd Quarter, per month	***1,00,000***	***3,00,000***
4th Quarter, per month	***0***	***4,00,000***

The Company has enforced a gradual enforcement of change in product line on the basis of an overall plan. The Board of Directors of the Company has passed a resolution in March to this

effect. The Company follows calendar year as its accounting year. Should it be treated as discontinuing operation?

Conclusion: *The changeover from Washing Soap to Bathing Soap is* ***not*** *a Discontinuing Operation.*

Question 4

Krishna Ltd produces 4 products. One of the products is identified as a Discontinuing Operation. Does this affect the Going Concern Assumption in its Financial Statements?

1. Effect on Going Concern: *The fact that a disposal of a component of an Enterprise is classified as a Discontinuing Operation under AS - 24 does not, in itself, bring into question the Enterprise's ability to continue as a Going Concern.*

2. ***Conclusion:*** *The Company's Financial Statements should be prepared under the Going Concern Assumption, notwithstanding the Discontinuing Operation,* ***unless other circumstances indicate that the Going Concern assumption may not be valid.***

AS-26: INTANGIBLE ASSETS

CA TEJAS SUCHAK
ACCOUNTANCY ACE

INTANGIBLE ASSET

An intangible asset is an;
- Identifiable,
- Non-monetary,
- Asset,
- Without physical substance,
- Held for use in the
  - Production of goods,
  - Supply of services,
  - Rental to others, or
  - Administrative purposes.

IDENTIFIABILITY

- Means an Intangible Asset(IA) which can be clearly distinguished from goodwill.

DISTINGUISHED

- An IA can be said to be distinguished from goodwill if it is separable.

SEPARABLE

- An IA is separable if enterprise can sell, rent, exchange, distribute the future economic benefits(FEB) attributable to the asset without disposing the FEB that flow from other assets used in same revenue generating activity.

ASSET

- A resource
- Controlled by the enterprise
- As a result of past events
- From which FEB are expected to flow to the enterprise.

NON-MONETARY

- Assets which can be defined in fixed /determinable amounts of money.

CONTROLLED BY ENTERPRISE

An enterprise controls an asset if:
- Enterprise has the power to obtain FEB from the underlying resource.
- Enterprise can restrict others from accessing the benefits that are derived from underlying resource.

PHYSICAL SUBSTANCE

- Sometimes IA may be contained on a physical substance ex: compact disk for a computer software, legal documents for a patent, film in case of motion pictures.
- The cost of physical substance is not significant. Hence asset is treated as without physical substance.

RECOGNITION OF INTANGIBLE ASSET

An IA should be recognised if & only if:
- It is probable that FEB that are attributable to the asset will flow to the enterprise.
- Cost of the IA can be measured reliably.

COST OF INTANGIBLE ASSET

Cost of IA comprises of:
- Purchase price
- Import duties & Taxes (except refundable ones).
- Directly attributable expenditure on making the asset ready for its intended use.

INTERNALLY GENEREATED INTANGIBLE ASSETS

- Internally generated goodwill, mastheads, brands, publishing titles, customer lists etc. should not be recognised.
- Other internally generated IA can be recognised subject to fulfilment of recognition criteria.

AS-26: INTANGIBLE ASSETS

CA TEJAS SUCHAK
ACCOUNTANCY ACE

RECOGNITION OF INTERNALLY GENERATED INTANGIBLE ASSETS

RESEARCH PHASE

- Under research phase investigation is undertaken with the prospect of gaining new scientific or technical knowledge/understanding.
- No asset is to be recognised during research phase.
- Research expenses are directly

DEVELOPMENT PHASE

- Under development phase, the findings/ knowledge gained during the research phase is applied to a plan/design for procing new/ substantially improved materials, devices.
- Recognise as asset only after recognition criteria is satisfied.

RECOGNITION CRITERIA

- Intention to complete the IA.
- Technical feasibility to complete the IA.
- Availability of adequate technical, financial & other resources to complete the IA.
- Ability to use or sell.
- Enterprise should be able to demonstrate existence of market or if IA used internally, then, usefulness of IA.
- Ability to measure the expenditure attributable to IA.

SUBSEQUENT EXPENDITURE ON INTANGIBLE ASSET

Expenditure on IA after its purchase or completion should be added to its cost only if:

- It is probable that the expenditure will enable the asset to generate FEB in excess of its originally assessed standard of performance.
- The expenditure can be measured & attributed to the asset reliably.

AMORTISATION

- It is the systematic allocation of depreciable amount of IA over its useful life.
- Amortisation commences once the asset is available for use.
- Amortisation period: generally assumed to be 10 years.

RESIDUAL VALUE

- Assumed to be zero, unless
- There is an active market for the asset
  - Residual market can be determined with reference to that market.
  - It is probable that the market will exist at the end of its useful life.

RETIREMENT & DISPOSAL OF INTANGIBLE ASSET

RETIREMENT: when an IA is retired from active use & held for disposal it is carried at its carrying amount on the date of such retirement & is tested for impairment at each B/S date.

DISPOSAL: Gains/losses(sale proceeds – carrying amount) is recognised in P&L.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

Question 1

A Company with a turnover of Rs. 250 Crores and an annual advertising budget of Rs. 2 Crores had taken up the marketing of a new product. It was estimated that the Company would have a turnover of Rs. 25 Crores from the new product. The Company had debited to its Profit & Loss Account, the total expenditure of Rs. 2 Crores incurred on extensive special initial advertisement campaign for the new product. Is the procedure adopted correct? [F (A/c) - N 06, P (A/c) - N16]

X Ltd is engaged in the business of Newspaper and Radio Broadcasting. It operates through different Brand Names. It incurred substantial amounts on external trade, business communication and branding expenses by participation in various Corporate Social Responsibility initiatives. The Company expects to benefit by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under Brand Development Expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the Statutory Auditor of the Company, do you concur? Give reasons.

*1. **No Concept of Deferred Revenue Expenditure:** With the introduction of AS 26, the concept of "Deferred Revenue Expenditure" no longer prevails except in respect of a very few items, i.e. Ancillary Costs on Borrowings, Shares Issue Expenses etc. AS 26 does not permit the Capitalization of Expenses incurred on Advertising or Brand Promotion etc.*

*2. **Conclusion:** Accounting Treatment given by the company is correct.*

Question 2

Note No. 6 of Published Accounts of Varalakshmi Ltd reads as follows -

"The Company being a manufacturer of pollution control equipment, has entered into collaboration agreements with foreign manufacturers for technical know-how comprising the supply of drawings and training of personnel for manufacture of different types of pollution control equipments. These agreements were concluded after the commencement of production at the beginning of the year. The collaboration amount of Rs. 100 Lakhs is payable in five annual instalments. The Company has amortised the entire cost of Technical Know-How as a depreciable asset and has shown the same in the schedule of Fixed Assets". As an Auditor state your views.

***1. Analysis:** In the given case, if the Company is able to establish the future economic benefits attributable to the Intangible Asset, the Company can **recognise** the expenditure of Rs. 100 Lakhs as a **separate Intangible Asset.** The Cost of the acquired Intangible Asset is Rs. 100 Lakhs, irrespective of the fact that the amount is payable in instalments.*

*2. **Treatment:** The consideration amount of Rs. 100 Lakhs should be recognised as a separate Intangible Asset and should be amortised over its Useful Life. The disclosures required under AS - 26 should be made in the Financial Statements.*

Question 3

A Company acquired for its internal use a Software on 28th January, from the USA for US $ 1,00,000. The Exchange Rate on that date was Rs. 52 per USD. The Seller allowed Trade Discount at 5%. The other expenditure were -

Import Duty:	***20%***
Purchase Tax:	***10%***
Entry Tax:	***5% (Recoverable later from Tax Department)***

Installation Expenses: ***Rs. 25,000***

Professional Fees for Clearance from Customs: ***Rs. 20,000***

Compute the cost of Software to be capitalized. ***]***

Historical Cost of Software is determined as under -

Particulars			***Rs.***
	Purchase Price ($1,00,000 × Rs. 52) [Spot Rate under AS 11]	*52,00,000*	
Less:	*Trade Discounts at 5% on above*	*(2,60,000)*	
	Net Invoice Value		*49,40,000*
Add :	*Import Duty (20% on Net Invoice Value)*		*9,88,000*
Add:	*Purchase Tax (assumed no credit available) 10% on (Net Invoice Value + Import Duty)*		*5,92,800*
Add:	*Installation Expenses*		*25,000*
Add:	*Professional Fees for clearance from Customs*		*20,000*
Total			***65,65,800***

Note: *Entry Tax is not added to the Cost of the Software since it is recoverable from the Tax Department.*

Question 4

A Pharma Company spent Rs. 33 Lakhs during the accounting year ended 31st March, on a research project to develop a drug to treat a dreaded disease. 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.

Conclusion: *Entire Expense relating to Research Phase should be treated as Expense when it is incurred.*

Question 5

In a year, an Enterprise incurred costs to develop & produce a routine, low risk computer software product, as follows -

1. ***Completion of detailed programme and design*** ***Rs. 25,000***
2. ***Pre-Coding and Pre-Testing*** ***Rs. 20,000***
3. ***Coding Costs*** ***Rs. 42,000***
4. ***Testing Costs*** ***Rs. 12,000***
5. ***Product Masters for Training Materials*** ***Rs. 13,000***

6. ***Duplication of Computer Software & Training Materials, from Product Masters (2,000 units)*** ***Rs. 40,000***

7. ***Packing the Product (1,000 units)*** ***Rs. 11,000***

What amount should be capitalized as software costs in the books of Company, on Balance Sheet date? ***[F (A/c) - RTP]***

The treatment of various expenditure items is as under -

Particulars	***Reason & Treatment***
1. Completion of detailed programme and design Rs. 25,000	*1. It is assumed that technological feasibility and asset recognition criteria are fulfilled only upon completion of design model.*
2. Pre-Coding & Pre-Testing Costs Rs. 20,000	*2. Hence, these items are treated as '**Expense**' in the year in which they are incurred.*
3. Coding Costs Rs. 42,000	*3. These are the costs of '**Development**' Phase, i.e. asset recognition criteria are satisfied.*
4. Testing Costs Rs. 12,000	*4. These Costs are **capitalized** as an Intangible Asset, as required under AS - 26.*
5. Product Masters for Training Materials Rs. 13,000	*5. These are Post-Development Costs and constitute Revenue Expenditure for the period in which they are incurred.*
6. Duplication of Computer Software & Training materials from Product Masters Rs. 40,000	*6. These Costs are treated as regular '**Expense**' items in the P&L A/c.*
7. Packing the product Rs. 11,000	

Question 6

Himalaya Ltd, in the past three years, spent Rs. 75,00,000 to develop a Drug to treat a dreaded disease, which was charged to P&L A/c since they did not meet the relevant Accounting Standard criteria for capitalization. In the current year, approval of the concerned Government Authority has been received. The Company wishes to capitalize Rs. 75,00,000 and disclose it as a Prior Period Item. Is it correct? Give reasons. [F (A/c) - N 05] [F (Aud) - N 99] [P(A/c) - RTP]

A Company had written off Rs. 18 Lakhs R&D expenditure in the P&L Account of previous years. To show a better financial position to its Bankers, it has recognised the same as an Intangible Asset during the current year, by crediting the General Reserves to that extent. Advise whether the accounting treatment is correct.

*1. **Principle:** As per Para 58 of AS - 26, expenditure on an intangible item that was initially recognised as an expense in previous Financial Statements or Interim Financial Reports, should **not** be recognised as part of the cost of an Intangible Asset at a later date.*

*2. **Analysis:** The R&D cost of Rs. 15 Lakhs which has already been charged to P&L Account in the past years, cannot be written back now.*

*3. **Conclusion:** The treatment adopted by the Company violates the principles of AS - 26.*

33. Rs. 5 Lakhs is paid by a Pharma Company to the Legal Advisor for defending the patent of a product, and has been treated as Capital Expenditure. Comment. / [P (Aud) - N 02]

Conclusion: *Since the conditions relating to recognition as Asset are not satisfied, the entire expense should be recognized as an Expense in the P&L A/c. Capitalisation is not proper.*

Question 7

Sunny Limited is developing a new production process. During the financial year ended 31st March 2017, the Company has incurred total expenditure of Rs. 40 Lakhs on the process. On 1st December 2016, the process has met the norms to be recognized as "Intangible Assets", and the expenditure incurred till that date is Rs. 16 Lakhs. During the financial year ending on 31st March 2018, the Company has further incurred Rs. 70 Lakhs. The Recoverable Amount as on 31st March 2018 of the process is estimated to be Rs. 62 Lakhs. You are required to work out:

(a) Expenditure to be charged to P&L A/c for FY ending on 31st March 2017 and 31st March 2018 (ignore Depreciation).

(b) Carrying Amount of the Intangible Assets as at 31.03.2017 and 31.03.2017.

1. ***Expenditure charged to P&L for 2016-2017:*** *Rs. 16 Lakhs will be recognized as an* ***Expense*** *because the recognition criteria were not met until 1st December 2016. This expenditure will* ***not*** *form part of the cost of the Production Process recognized in the Balance Sheet.*

2. ***Carrying Amount of Intangible Asset as on 31.03.2017:*** *Production Process will be recognized (i.e. Carrying Amount) as an Intangible Asset at a cost of Rs. 24 Lakhs (i.e. expenditure incurred till the date in which recognition criteria were met, i.e. Total during FY 2016-2017 Rs. 40 Lakhs* ***less*** *Expenses upto 1st Dec 2016 Rs. 16 Lakhs).*

3. ***Expenditure charged to P&L A/c for 2017-2018:***

Particulars		***Rs. Lakhs***
Less:	*Book Value on 31.3.2018 = Carrying Amt on 31.3.2017 + Expenditure in 2017-2018 = 24 + 70 Recoverable Amount*	*94* *62*
	Impairment Loss to be charged to P&L A/c	***32***

4. ***Carrying Amount of Intangible Asset as on 31.03.2018:*** *The Production Process will be shown at Book Value Rs. 94 Lakhs, or Recoverable Amount Rs. 62 Lakhs, whichever is less, hence at Rs.* ***62 Lakhs*** *as above.*

Question 8

Veni Ltd had acquired a Brand from another Company for Rs. 100 Lakhs. Veni Ltd contends that since the said brand is a very popular and famous brand, no depreciation or amortization needs to be provided. Comment.

Conclusion: *The contention of the Company, that the Brand is very popular and famous, no depreciation or amortization needs to be provided, is wrong in view of the above and hence, the Auditor will have to qualify his report in this matter and quantify, the amount of non-amortization.*

Question 9

Visalakshi Private Limited, started stock-broking activities during the year. For this purpose, it acquired Membership of a Stock Exchange for Rs. 110 Lakhs. While finalizing the accounts, the Company disclosed the above amount under the Fixed Asset Schedule as "Stock Exchange

Membership Rights". The Company also did not write off any amount since the rights would enable the Company to perpetually carry on its business. Comment.

Radhika Ltd has spent a substantial amount on purchase of Goodwill, Trademarks and Copyrights of which 95% of the amount has been spent on the purchase of Trademarks and Copyrights. The Company is not willing to amortise these Intangible Assets in the financial records on the contention that these are permanent in nature and do not require any amortisation. Comment.

• ***Recognition of Intangible Asset: Refer to Definition of Intangible Asset and Recognition Criteria given above.*** *Membership Rights acquired by the Company meet the definition and recognition criteria of Intangible Asset, and the Company's accounting treatment as regards recognition as "Asset" is correct.*

• ***Amortisation: Refer to Amortization principles given above.*** *The Company has to write-off the Cost of Intangible Asset, over its useful life. Since the Company has not amortised any amount, the Auditor will have to qualify his report and state the fact of non-compliance with AS-26.*

Question 10

Kamala Ltd purchased a trademark from Arundhati Ltd for Rs. 300 Lakhs, after it was used by the latter for four years. As per the industry norms, the expected useful life of such a trademark is 18 years. Kamala Ltd wants to amortise the trademark over its remaining useful life of 14 years whereas AS - 26 permits only a 10 year life. Comment.

*1. **Rebuttable Presumption:** AS - 26 assumes that the useful life of an Intangible Asset will not exceed a period of 10 years, but this presumption is rebuttable.*

*2. **Conclusion:** In the instant case, Kamala Ltd can estimate the balance expected useful life of the Trademark as 14 years and hence amortise the cost of Rs. 300 Lakhs over that period.*

Question 11

Vaishnavi Ltd has incurred expense for purchase of Technical Know-how for manufacturing a Moped. The Company has paid Rs. 5 Crores for use of Know-How for a period of 4 years. The Company estimates production of mopeds as follows -

Year	***1***	***2***	***3***	***4***
No. of Mopeds	***25,000***	***50,000***	***75,000***	***1,00,000***

On going into production, at the end of the 1st year it achieved its targeted production, but the Company decided to revise the estimates for the next 3 years as follows -

Year	***1***	***2***	***3***
No. of Mopeds	***35,000***	***65,000***	***80,000***

(a) How will the Company amortise the Technical Know-How Fees as per AS - 26?

(b) Whether the amortisation should be directly charged as an Expense or should it form part of Production Cost of Mopeds?

1. Principle: Refer to principles relating to Amortisation, change in method thereof, etc.

*When the pattern of use cannot be determined reliably, **Straight-Line Method** should be used. This is the default method recognised by AS - 26.*

*2. **Analysis:***

(a) In the above case, total production estimate = 25,000 + 35,000 + 65,000 + 80,000 = 2,05,000 units. Hence, the total cost of Rs. 5 Crores can be apportioned using the Production Units Method, if the estimates are ***reliable.***

(b) However, it is observed that the pattern of production is not even, i.e. higher production quantities in later years. Therefore, ***SLM is more preferable*** *in this case, since this will avoid postponing of considerable amortization amounts to later years.*

3. ***Conclusion:***

(a) The Company may write off an amount of Rs. 5 Crores ÷ 4 years = Rs. 1.25 ***Crores*** *as amortization amount under Straight Line Method.*

(b) Amortisation of Intangible Assets used in Production Process is included as Cost of Inventory under AS - 2. Hence, this amount should form part of Production Cost of Mopeds.

Question 12

Srimathi Ltd acquired patent right for Rs. 400 Lakhs. The product life cycle has been estimated to be 5 years and the amortization was decided in the ratio of estimated future cash flows which are as under -

Year	***1***	***2***	***3***	***4***	***5***
Estimated Future Cash Flows (Rs. in Lakhs)	***200***	***200***	***200***	***100***	***100***

After 3rd year, it was ascertained that the Patent would have an estimated balance future life of 3 years and the Estimated Cash Flow after 5th year is expected to be Rs. 50 Lakhs each year. Determine the amortization under AS-26

1. Initial Estimate of Total Cash Inflow = 200 + 200 + 200 + 100 + 100 = Rs. 800 Lakhs

2. So, as per initial estimate, the cost of Patent should be written off in the ratio 2 : 2 : 2 : 1 : 1, i.e. (Rs. Lakhs) 100, 100, 100, 50 and 50 respectively, for the five years.

3. Unamortised Amount (WDV) of Patent at the end of 3rd year = 400 - (100+100+100) = Rs. ***100 Lakhs.***

4. Revised Estimate of Useful Life at the end of 3rd year = ***3 further years,*** *with estimated Cash Inflows being as under - Year 4: Rs. 100 Lakhs, Year 5: Rs. 100 Lakhs, Year 6: Rs. 50 Lakhs.*

5. Hence, the unamortised Carrying Amount should be written off over the next 3 years, in the ratio of 100 : 100 : 50, i.e. Rs. 40 Lakhs, Rs. 40 Lakhs and Rs. 20 Lakhs respectively, for Years 4, 5 and 6.

AS-29: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

CA TEJAS SUCHAK
ACCOUNTANCY ACE

PROVISION

A Provision is a

- Liability
- Measured using a substantial degree of estimation.

LIABILITY

A Liability is a

Present Obligation of the enterprise.

PRESENT OBLIGATION

- A Present obligation arises as a result of PAST EVENT.
- To be called a present obligation, such obligation should exist on B/S Date.
- When it is not probable that a present obligation exists, the enterprise should disclose it as a contingent liability.

OBLIGATION

- Duty or responsibility to act in a specific manner.
- May or may not be legally enforceable.
- Contract, stat. req. – legally enfor.
- Normal buss. Practices, buss. customs, maintaining good buss. relations- not legally enf. EXAMPLE- WARRANTY CLAIMS.

RECOGNITION OF PROVISIONS

- A Provision should be recognised only when the following 3 conditions are satisfied :-
  1. An enterprise has present obligation as a result of past event;
     (obligations i.e. costs/expenditures that can arise as a result of future activities of enterprise not to be recognised as provisions.)
  2. It is probable that an outflow of resources embodying future economic benefits (costs>benefits) will be required to settle the obligation; AND
  3. Reliable estimate of the amount of obligation can be made.

PROBABLE OUTFLOW OF RESOURCES EMBODYING FUTURE ECONOMIC BENEFITS

PROBABLE :- When the likelihood of the happening of the event is greater than the likelihood of it not happening, such event is called probable.
(LIKELIHOOD IS > 50%)

- When the likelihood of outflow of resources is greater than 50%, it is called probable outflow of resources.
- Where the outflow of resources is not probable:- disclose as contingent liability unless the chances are outflow is REMOTE(chances<10%). In this case even disclosure is not required.

RELIABLE ESTIMATE

- A Provision should be recognised only when a reliable estimate of the amt. of obligation can be made.
- If such estimate cannot be made, disclose such liability as a contingent liability.

REVIEW OF PROVISIONS

- A Provision should be reviewed at each B/S date & also be adjusted to reflect the Best Estimate(Most Reliable Estimate).
- If outflow of resources is no longer PROBABLE for settlement of an obligation, the provision needs to be reversed.

IMPORTANT POINTS

- A provision can be used only for the purpose for which it is made.
- Provisions which are adjustments to carrying amounts of assets such as
  - Doubtful debts
  - Depreciation
  - Impairments

are not covered by this AS. This AS covers only provisions in respect of liabilities.

- An obligation is always owed to a third party. It is not necessary to know the identity of the third party, obligation may be owed to the public at large.
- If a new law requires the damage caused by an enterprise by its past actions to be rectified, such event(damage caused by an enterprise) will be considered an obligating event in the year in which such damage needs to be rectified.
- Provision not to be discounted to its PV.
- If an expenditure is expected to be reimbursed from third party on settling an obligation, such reimbursement should be recognised only when it is VIRTUALLY CERTAIN that reimbursement will be realised. It is treated as a separate asset & its amount should not exceed amount of provision. In P&L net amt. may be presented.

CONTINGENT LIABILITY

1.A POSSIBLE Obligation, that arises from past events and
- existence of which will be confirmed only by happening or non- happening of one or more future events
- not wholly within the control of the enterprise.

POSSIBLE OBLIGATION

An obligation is considered POSSIBLE if on the B/S Date its existence is NOT CONSIDERED PROBABLE(50%>=)

2. A PRESENT Obligation that arises from past events, but not recognised as
- it is NOT PROBABLE that an outflow of resources embodying future economic benefits will be required to settle the obligation (possible outflow).
- A reliable estimate of the amount of obligation CANNOT be made.

RECOGNITION OF CONTINGENT LIABILITIES

- A Contingent Liability should NOT be recognised i.e. a provision should not made for it.
- A Contingent Liability should be DISCLOSED. If the chances are outflow of resources is REMOTE, even disclosure is not required.

NOTE:- In case of joint liability, the part of liability which is to be met by the other party is treated as Contingent Liability.

REVIEW OF CONTINGENT LIABILITY

- Should be reviewed at each B/S date.
- If outflow of resources becomes probable, provision should be recognised for such contingent liability.

CONTINGENT ASSETS

- Is a possible asset that arise from the past events.
- Existence of which is confirmed by happening or non happening of uncertain future event.
- Neither recognised nor disclosed in financial statements, disclosed only in report of approving authority.
- Reviewed at each B/S date.

ONEROUS CONTRACTS

- One where the unavoidable costs of meeting the obligations under the contract > the economic benefits expected to be received under it.
- Provision needs to be recognised & measured for onerous contract at the lower of:
  - Costs of Fulfilling the contract.
  - Compensation arising from failure to fulfil it.

RESTRUCTURING & ITS PROVISION

- Is a program that is planned & controlled by management & materially changes either:
  - The scope of a business undertaken by an entity; or
  - The manner in which that business is conducted.

    Eg:- Sale, Termination, Closure of business, changes in mgmt. structure.
- A Provision should be recognised only when the recognition criteria of provisions are met. No need to recognise a provision for sale of an operation until the enterprise has entered into a binding sale agreement.
- Restructuring provision includes only DIRECT EXPENSES arising from restructuring, which are
  - Necessarily entailed by the restructuring AND
  - Not associated with ongoing business activities of the enterprise.

CA TEJAS SUCHAK
ACCOUNTANCY ACE

Question 1

An Airline is required by law to overhaul its aircraft once in every three years. A Company which operates aircrafts does not provide any provision as required by law in its final accounts. Discuss with reference to relevant Accounting Standard.

*1. **Relevant Provision:** As per AS - 29, provision shall be created when there is a present obligation as a result of past events and it is probable that the outflow of resources may happen whose amount can be measured reliably.*

*2. **Analysis:***

(a) In the given case, the Airline Company is required by law to overhaul its aircrafts once in every three years.

(b) Hence, the Company shall create provision for repairs based on its past experience regarding the amount spent on repairs for each year.

(c) In the year of overhaul, the actual overhaul expenses shall be compared with the provision and any difference shall be appropriately debited / reversed in Profit and Loss Account.

*3. **Conclusion:** The Company has to create provision for repairs based on its past experience. If the provision is not created, then the profits shall be considered as over-stated to that extent.*

Question 2

Mini Ltd took a factory premises on lease on 01.04.2016 for Rs. 2,00,000 per month. The lease is an Operating Lease. During March 2017, Mini Ltd relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2018. The Lease cannot be cancelled and cannot be sub-let to another user. The Auditor insists that lease rent of balance 33 months upto 31.12.2018 should be provided in the accounts for the year ending 31.3.2017. Mini Ltd seeks your advice. [F (A/c) - M 08]

*1. "Onerous Contract" is a contract in which the unavoidable costs of meeting the obligation under the Contract **exceeds** the economic benefits expected to be received under it.*

2. In the given case, the Operating Lease Contract has become onerous, as the economic benefit of lease contract for next 33 months up to 31.12.2018 will be Nil.

3. However, the Lessee, Mini Ltd has to pay lease rent of Rs. 66,00,000 (i.e. 2,00,000 p.m. for next 33 months). Therefore, provision on account of Rs. 66,00,000 is to be made in the accounts for the year ending 31.03.2018, in accordance with AS - 29 requirements.

Question 3

Raghav Ltd had a major break down in its plant in the month of February, in the month of March it entered into an agreement with an Engineering Firm for the purpose of repairing its plant for a consideration of Rs. 180 Lakhs. The Engineering Firm started the repairing work in the month of April and completed it in the same month. Raghav Ltd made the Provision for said expenditure on repairs in its books of account for the financial year ended 31st March on the plea that the event of break down leading to repair expenditure had taken place in that financial year, binding contract for repairs was entered into during the same financial year & repair work was also completed before the Financial Statements were approved by the Company's Board of Directors. Comment

*1. **Recognition:** As per AS - 29, a Provision should be recognized if the following conditions are satisfied -*

Condition (1)	Condition (2)	Condition (3)
Present Obligation *as a result of past event.*	***Outflow of Resources*** *to settle the obligation is probable.*	*Reliable* ***estimate*** *of the amount.*
Break down of the plant and binding contract for repairs is entered into, during the financial year ending 31st March but the Engineering Firm has ***not started*** *performing the work of repair until the date of Balance Sheet. Hence, there is* ***no present obligation.***	*Payment should be made to the Engineering Firm as per the Binding Contract on completion of the repairs and hence outflow of resources is probable.*	*Sum payable on account of repairs is Rs. 180 Lakhs.*

2. ***Treatment and Conclusion:***

(a) Since all the conditions for recognition of a Provision are not satisfied, a Provision should ***not*** *be recognized for the year ending 31st March.*

(b) Hence, Provision made by Raghav Ltd for expenditure on repairs in its books of account for repair work to be done in the next Financial Year is ***wrong,*** *as there was no obligation.*

Question 4

Company who is seeking damages of a huge sum of Rs. 900 Lakhs. The Directors are of the opinion that the claim can be successfully resisted by the Company. How would you deal with this in the annual accounts of the Company?

1. Recognition: *As per AS - 29 a Provision should be recognized if the following conditions are satisfied -*

Condition (1)	Condition (2)	Condition (3)
Present Obligation *as a result of past event.*	***Outflow of Resources*** *to settle the obligation is* ***probable.***	***Reliable Estimate*** *of the amount.*
There is ***no present obligation*** *to pay any damages, as the matter is still in dispute.*	*Directors of the Company are of the opinion that the claim can be successfully resisted by the Company, therefore there will be* ***no outflow*** *of resources.*	*Rs. 900 Lakhs is only a claim amount by the other party, not the amount of damages payable.*

2. ***Treatment and Conclusion:*** *Since none of the conditions for recognition of a Provision are satisfied, the Provision should* ***not*** *be recognized for the year ending 31st March. However, if a long-drawn legal battle is anticipated, then legal expenses therefor should be provided for. The Company will disclose the above matter as a Contingent Liability by way of the following Note:*

"Litigation is in process against the Company relating to a dispute with a Competitor who alleges that the Company has infringed Patents, and is seeking damages of Rs. 900 Lakhs. However, the Directors are of the opinion that the claim can be successfully resisted by the Company. Estimated Legal Expenses for the above is provided for."

Question 5

Rajeev Ltd was under audit for the year-ended 31st March. An appeal filed by Rajeev Ltd against the demand of Excise Duty of Rs. 26 Crores was pending before the Supreme Court for which neither Provision was made nor was disclosed in the Notes to the Financial Statements. On 12th

July (i.e. subsequent to the Balance Sheet date), the Auditor came to know through paper reports that the point involved in the appeal of Rajeev Ltd was adjudicated by the Supreme Court in the case of some other assessee, which is in favour of the Department of Excise Duty. The Auditor insisted that Provisions be made of Rs. 26 Crores in the Financial Statements. The Management was of the view that since its own case is still pending, no Provision is called for. It was also of the view that the event does not have any effect on the financial position of the Company on the Balance Sheet date. Is the Management's view correct?

*1. **Recognition:** As per AS - 29 a Provision should be recognized if the following conditions are satisfied -*

Condition (1)	***Condition (2)***	***Condition (3)***
Present Obligation *as a result of past event.*	***Outflow of Resources*** *to settle the obligation is* ***probable.***	***Reliable Estimate*** *of the amount.*
Excise Duty demand is already made on the Company. Hence present obligation exists at the Balance Sheet date.	*Additional evidence arising after Balance Sheet date lead to the conclusion that the outflow is probable i.e. more likely than not.*	*Rs. 26 Crores is the amount of the liability. (Given)*

*2. **Treatment and Conclusion:** Since all the conditions for recognition of a Provision are satisfied, the Provision should be recognized for the year ending 31st March. If the amount is material, separate disclosure is also required. The Management's contention is not tenable.*

Question 6

Big and Small Ltd received a show cause notice in December 2017 from the Central Excise department intending to levy a sum of Rs. 25 Lakhs. The Company replied to the above Notice in January 2018 contending that it is not liable for the proposed levy. No further action was initiated by the Central Excise Department up to the finalization of the audit for the year ended on 31st March 2018. As the Auditor of the Company, how would you deal with this matter in your Report?

Solution: *Conditions relating to recognition of Provision under AS-29 are not satisfied. Hence no need to report the same.*

Question 7

Quick Ltd is a Company engaged in the trading of spare parts used in the repair of automobiles. It has been regular in depositing the tax, as such there is no liability of Income Tax, etc for FY 2017-2018. The figures for the year are as under - Income chargeable to Tax Rs. 211.64 Lakhs TDS deducted during the year Rs. 30.45 Lakhs

Total Income after Adjustments Rs. 228.48 Lakhs Tax paid for the year Rs. 43.68 Lakhs

Tax thereon Rs. 74.13 Lakhs

The Company has prepared its Balance Sheet as per above figures. However, during the Assessment Proceeding held before the finalization of the Balance Sheet, the Income Tax Officer has issued demand of Rs. 7.52 Lakhs, insisting that this amount of TDS has not been uploaded online and thus is not acceptable as deduction.

The Company has in reply to the same filed a Rectification with the Assessing Officer. The Company is trying to collect the TDS Certificates, but Rs. 2.39 Lakhs deducted by XY Ltd, is not traceable. The Rectification is lying pending with the Assessing Officer. Please suggest the treatment of Rs. 2.39 Lakhs and Rs. 7.52 Lakhs in Balance Sheet.

1. ***For TDS of Rs. 2.39** = **Recognition:** As per AS-29, Provision should be recognized if following conditions are satisfied -*

Condition (1)	*Condition (2)*	*Condition (3)*
***Present Obligation** as a result of past event.*	***Outflow of Resources** to settle the obligation is **probable.***	***Reliable Estimate** of the amount.*
*Liability for Income Tax existed on the B/S date, as per Demand. There is a **present obligation.***	*There will be an **outflow of resources** to settle the obligation on account of nontraceability of TDS Certificates.*	*Tax Liability is ascertained at Rs. 2.39 Lakhs, as per the Demand Notice.*

Since there is a probability of outflow of resources and also the amount can be quantified on account of non-traceability of TDS Certificates, a provision may be made for Rs. 2.39 Lakhs in the books.

2. ***For Balance Amount:** TDS Certificates for Rs. 5.13 Lakhs (Rs. 7.52 Lakhs **Less** Rs. 2.39 Lakhs) have been submitted and the Company has filed a rectification with the Assessing Officer. Therefore, the possibility of an outflow of resources embodying economic benefits is remote. So, the Company shall not disclose it as Contingent Liability. It should be disclosed by way of a Note to Accounts.*

Question 8

Rama Ltd was involved in wage negotiations with trade unions of their organisation as on 31st March 2017. Wage revision proposals could be finalised only after obtaining the final approval from the Head Office of the Company located at Mumbai. The final approval was granted on 9th April 2018 w.e.f from 1st April 2016. The settlement covered the period from 01.04.2016 to 31.03.2018. The liability upto 31st March 2018 was disclosed on account of the above settlement in the Notes forming part of the Accounts. As an Auditor, you may advise whether such disclosure is proper.

1. ***Recognition:** As per AS - 29 a Provision should be recognized if the following conditions are satisfied -*

Condition (1)	*Condition (2)*	*Condition (3)*
***Present Obligation** as a result of past event.*	***Outflow of Resources** to settle the obligation is probable.*	***Reliable estimate** of the amount.*
Wage revision is for the period covered by Financial Statements, i.e. 2017- 2018, and consists of the Company's present obligation.	*Post Balance Sheet date events (i.e. sanction from HO) that the payment of revised wages is probable, i.e. more likely than not.*	*Though not quantified in the question, wage payable on the revised scale can be estimated reliably.*

2. ***Treatment and Conclusion:** Since all the conditions for recognition of a Provision are satisfied, a Provision should be recognized for the year ending 31st March 2018. Also, under **AS - 5,** when items of Income and Expenses within Profit / Loss from ordinary activities are of such size, nature or incidence, that their disclosure is relevant to explain the performance of the Enterprise for the period, they should be **disclosed separately.** Since the Company has only disclosed the fact and not created any provision, the treatment given by the Company is **not correct.***

Question 9

A Company is in the process of finalizing its Accounts for the year ended 31st March 2018. The Company seeks your advice on the following:

(a) The Company's Sales Tax Assessment for the Assessment Year 2015-2016 has been completed on 14th February 2018 with a demand of Rs. 2.76 Crore. The Company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the Appellate Authority wherein the grounds of appeal cover Tax on additions made in the Assessment Order for a sum of Rs. 2.10 Crore.

(b) The Company has entered into a Wage Agreement in May 2018 whereby the Labour Union has accepted a revision in wage from June 2017. The agreement provided that the hike till May 2018 will not be paid to the employees but will be settled to them at the time of retirement. The Company agrees to deposit the arrears in Government Bonds by September 2018.

1. Since the Company is not appealing against the addition of Rs. 0.66 Crore, the same should be provided for in its Accounts for the year ended on 31st March 2018. The amount paid under protest can be kept under the heading "Loans and Advances" and disclosed along with the Contingent Liability of Rs. 2.10 Crore.

2. The Arrears for the period from June 2017 to March 2018 are required to be provided for in the Accounts of Company for the year ended on 31st March 2018.

Question 10

Skanda Ltd had made an appeal before the Income Tax Appellate Tribunal on its Income Tax Assessment. The case was lost and accordingly a demand notice for Rs. 25 Lakhs was received towards the Company's tax liability. The Company has however, preferred an appeal in the High Court before the end of the financial year, which is pending as on the Balance Sheet Date and also till the approval of Financial Statements by the Board of Directors. The Company has not provided for the liability and also feels that no disclosure is required. Comment.

*1. **Recognition:** As per AS - 29 a Provision should be recognized if the following conditions are satisfied -*

Condition (1)	***Condition (2)***	***Condition (3)***
***Present** obligation as a result of past event.*	***Outflow of resources** to settle the obligation is probable.*	*Reliable **estimate** of the amount.*
*Liability for Income Tax existed on the B/S date, as per the Tribunal order. There is a **present obligation.***	*There will be an **outflow of resources** to settle the obligation, if the Company does not win the case in the High Court.*	*Tax Liability is ascertained at Rs. 25 Lakhs, as per the Demand Notice.*

***Note:** Merely because an appeal has been made before the higher appellate authorities, the character of the obligation is not lost.*

*2. **Treatment and Conclusion:** Since all the conditions for recognition of a Provision are satisfied, a Provision for Tax Liability Rs. 25 Lakhs should be recognized for the above financial year. The Company's contention not to make any provision or disclosure, violates AS - 29 requirements.*

Question 11

A claim for damages of Rs. 10 Lakhs for breach of patents and copyrights had been served on Radha Ltd in January.

The Directors sought competent legal advice on the eligibility of the claim and were advised that the claim was highly frivolous, without any basis and would not survive even in the first trial court. The Company, however, anticipates a long drawn legal battle and huge legal costs. The Company's accounts for the year ended 31st March were considered and approved by the Board of

Directors on 15th May. How will you treat the above in the accounts for the year ended 31st March?
1. Analysis:

(a) The Company's liability for damages, if any, will be confirmed only after the occurrence of future events, i.e.

hearing by the Court. Hence, the given situation is a ***Possible Obligation.***

(b) At the Balance Sheet date, it was not probable that events subsequent thereto would confirm that a liability has

been incurred.

Question 12

A Company has given counter guarantees of Rs. 5 Crores to various banks in respect of the guarantees given by the said banks in favour of Government Authorities. Outstanding counter guarantees as at the end of the financial year were Rs. 4 Crores. How this information should be shown in the Financial Statements of the Company? *1. The Counter-Guarantee given by the Company is effectively an undertaking to perform what is in any event, an obligation of the Company.*

2. In any case, this is a matter which is in the control of the Company itself and the possibility of the Company defaulting in future does not mean that Contingent Liability exists on the Balance Sheet date.

3. No separate disclosure is required in respect of the Counter-Guarantees [As per ICAI's Guidance Note on "Guarantees and Counter-Guarantees given by Companies"].

Question 13

Included under Sundry Creditors was Fees Payable to the Legal Counsel for suits filed against the Company. The Company is not aware of the status of the suits and, hence, did not want to provide for the same. Describe your views on the above. [P (Aud) - N 98]

1. ***Provision:*** *In the given case, the Management should analyse each case / suit and assess whether there will be any actual liability on account of final outcome of the legal suits. If the conditions relating to recognition of a Provision under Para 14 are satisfied, a* ***Provision*** *should be recognised as per AS - 29.* [2]

2. ***Contingent Liability:*** *In relation to suits where the very basis of the legal obligation is being contested, i.e. Possible Obligation or Present Obligation where outflow of resources is not probable, it is adequate if their disclosure is made as a* ***Contingent Liability,*** *in the manner required under AS - 29.*

Question 14

A Company has at its financial year ended 31st March, 15 law suits outstanding, none of which has been settled by the time the accounts are approved by the Directors. The Directors have estimated that the possible outcomes are as below -

Results	***For first ten cases***		***For remaining five cases***	
	Probability	***Amount of Loss***	***Probability***	***Amount of Loss***
Win	***0.6***	-	***0.5***	-
Lose - low damages	***0.3***	***Rs. 90,000***	***0.3***	***Rs. 60,000***
Lose - high damages	***0.1***	***Rs. 1,60,000***	***0.2***	***Rs. 95,000***

The Directors believe that the outcome of each case is independent of the outcome of all of the others. Estimate the amount of Contingent Loss and state the accounting treatment of such Contingent Loss.

*1. **Nature of Obligation:** The probability of winning the suits is 60% for first ten cases and 50% for the remaining five cases. Thus the probability of losing is 40% and 50% respectively. As the loss does not appear to be probable, the possibility of an outflow of resources embodying economic benefits is not probable. Therefore, the proper treatment is to disclose the Contingent Liability (and not Provision) as required under AS - 29.*

*2. **Determination of Probable Losses:***

Category	***Probable Loss per case***	***Total Probable Loss***	***Total Maximum Loss***
First Ten Cases	*90,000 × 0.3 = 27,000* *1,60,000 × 0.1 = 16,000*	*Rs. 43,000 × 10 cases =* *Rs. 4,30,000*	*Rs. 1,60,000 × 10 cases =* *Rs. 16,00,000*
	Total = 43,000		
Remaining Five Cases	*60,000 × 0.3 = 18,000* *95,000 × 0.2 = 19,000*	*Rs. 37,000 × 5 cases =* *Rs. 1,85,000*	*Rs. 95,000 × 5 cases =* *Rs. 4,95,000*
	Total = 37,000		
Total		***Rs. 6,15,000***	***Rs. 20,95,000***

*3. **Disclosure:***

(a) Disclosure of Contingent Liability on the basis of maximum loss at Rs. 20,95,000 will be highly unrealistic since it does not recognize the probability of winning some cases and paying low damages in some cases.

(b) It will be advisable to disclose the overall expected loss of Rs. 6,15,000 as Contingent Liability not provided for in the accounts.