dronacharya

FOR

CA INTERMEDIATE

2024

MARATHON / ONE SHOT / SUPER REVISION

Advanced Accounting **PART 3**

By – Nitin Goel

CA INTER MARATHON (SUPER REVISION/ONE SHOT)

ADVANCED ACCOUNTING

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Investment

(Assets held for the purpose of earning Income)

- Revenue Nature
  - Dividend (Shares)
  - Interest (Deb./Bonds)
  - Rentals (Investment Property)
- Capital Nature
  - Capital Appreciation (Investment Property)

Classification of Investments

[On the basis of Period of Holding]

- Current Investment/ Short term Investment [Intention to hold ≤ 1 Year]
  - Valued at Lower of Cost **Or** Market value / Fair value
- Non Current Investment/ Long Term Investment [>1 Year]
  - Valued at Cost [Unless there is permanent decline]

Classification of Investments

[On the basis of Income]

- Fixed Income Bearing Scrips/Securities (FIBS)
  - Debentures, Bonds, Govt. securities
- Variable Income Bearing Scrips/Securities (VIBS)
  - Equity shares

Fixed Income Bearing Scrips / Securities (FIBS)

(Journal Entries)

1) Purchase of Investment

Investment A/c - Dr
Interest on Inv. A/c - Dr
To Bank A/c

2) Receipt of Interest

Bank A/c - Dr
To Interest on Inv. A/c

3) Sale of Investment

Bank A/c - Dr
To Investment A/c
To Interest on Inv. A/c

4) Profit / (Loss) on Sale

Profit: Investment A/c - Dr
To P&L A/c

Loss: P&L A/c - Dr
To Investment A/c

Notes:

1) Interest is always calculated on Face Value

2) Transaction can be Ex-interest or Cum-interest

Ex-interest : Excluding Interest
Cum-interest : Including Interest

3) Cost of Investment

Purchase cost	xx
+ Brokerage / Commission	xx
+ Stamp Duty	xx
	xx

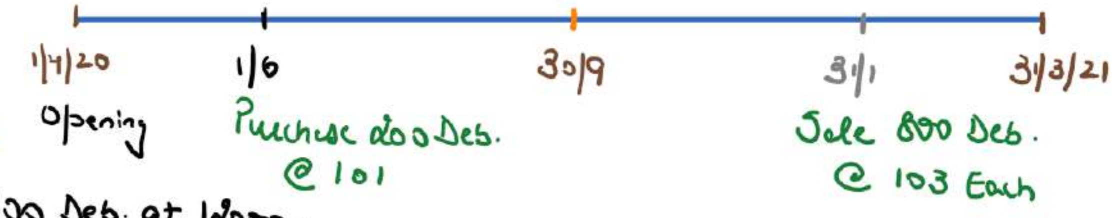
4) Incidental Expenses like brokerage, commission, etc.

Purchase : + Sale : -

Example:

Investment in 12% Deb. of X Ltd.

FV = 100
ROI = 12%
Int: 30/9, 31/3



1000 Deb. at 120000

Case 1: (FIFO) Brokerage 2%, Ex-interest

Investment in 12% Deb. of X Ltd. A/c

Date	Particulars	Nominal	Interest	Amount	Date	Particulars	Nominal	Interest	Amount
1/4	To Bal b/d	100000	–	120000	30/9	By Bank A/c	–	7200③	–
1/6	To Bank A/c	20000	400①	20604②	31/1	By Bank A/c	80000	3200④	80752⑤
31/3	To P&L A/c	-	12400			By P&L (Loss)	–	–	15248⑥
					31/3	By Bank	–	2400⑦	-
						By Bal c/d	40000	–	44604

1) Interest = 20000 × 12% × 2/12 = 400

2) Cost = 200 × 101 = 20200
+ 2% Brokerage = 404
20604

3) Interest = 120000 × 12% × 6/12 = 7200

4) Interest = 80000 × 12% × 4/12 = 3200

5) Sale = 800 × 103 = 82400
− 2% Brokerage = (1648)
80752

6) Profit/Loss
Cost = 120000/100000 × 80000 = 96000
Sale = 80752
Loss 15248

7) Interest = 40000 × 12% × 6/12 = 2400

Case 2: Brokerge 2%, Cum Interest
(FIFO)

W.N: 2 Purchase

Cost = 200 X 101 = 20200
+ Brokerge 2% = 404
− Interest = (400)
20204

W.N.5. Sale

Sale = 800 X 1.03 = 82400
− Brokerge 2% = (1648)
− Interest = (3200)
77552

W.N.6 Profit/(Loss)

Cost of Inv. sold = 96000
− Sale Proceeds = (77552)
Loss 18448

Case 3: Brokerge 2%, Ex-interest
(Weighted Avg./Avg. Cost)

Date		Nominal	Cost	Sale	Profit/(Loss)
1/4	Opening	100000	120000		
1/6	Purchase	20000	20604		
		120000	140604		
31/1	Sale	(80000)	(93736)	80752	12984 Loss
		40000	46868		

Case 4: Same as Case1

Market value on 31/3 a) 120 b) 105

31/3 Balance

Nominal value = 40000 Cost = 44604

Assuming Current Investments, valued at Lower of Cost or Market value.

a) Market value = 400 X 120 = 48000
Value = 44604

b) Market value = 400 X 105 = 42000
Value = 42000 Loss Recognised = 2604

Example:

Investment in 12% Deb. of X Ltd.

FV = 100

ROI = 12%

Int: 30/6 & 31/12

1/4/20 Opening: 1000 Deb. at 120000

1/6 Purchase 200 Debs. @ 101

31/1 Sale 800 Deb. @ 103 Each

Case 1: (FIFO) Brokerage 2%, Ex-interest

Inv. in 12% Deb. of X Ltd. A/c

Date	Particulars	Nominal	Interest	Amount	Date	Particulars	Nominal	Interest	Amount
1/4	To Bal b/d	100000	3000 ①	120000	30/6	By Bank A/c	—	7200 ④	—
1/6	To Bank A/c	20000	1000 ②	20604 ③	31/12	By Bank A/c		7200	
					31/1	By Bank A/c	80000	800 ⑤	80752 ⑥
31/3	To P&L A/c	-	12400			By P&L (Loss)	—	—	15248 ⑦
					31/3	By Bal c/d	40000	1200 ⑧	44604

1) Opening Acc. Int. = 100000 × 12% × 3/12 = 3000

2) Interest = 20000 × 12% × 5/12 = 1000

3) Cost = 200 × 101 = 20200
+ 2% Brokerage = 404
20604

4) Interest = 120000 × 12% × 6/12 = 7200

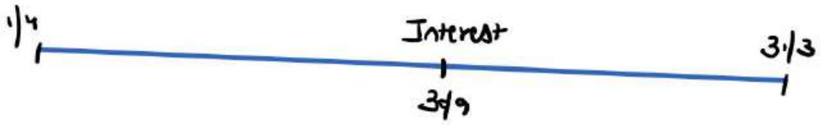
8) Interest = 40000 × 12% × 3/12 = 1200

5) Interest = 80000 × 12% × $\frac{1}{12}$ = 800

6) Sale: 800 × 103 = 82400
−2% Brokerage = (1648)
80752

7) Profit / Loss
Cost = $\frac{120000}{100000}$ × 80000 = 96000
Sale = 80752
Loss 15248

Points to Remember:



Case 1: Transaction on 1/10 (After Interest Date)

a) Ex-interest = Interest = Nil

b) Cum interest : Interest = Nil

Case 2: Transaction on 30/9 (On the Day of Interest)

a) Ex-interest = Can be Ist Transaction & then interest (or) Vice versa.

b) Cum interest : First transaction & then interest

Question: Inter Nov 2019 (10 Marks)

Mr. Harsh provides the following details relating to his holding in 10% debentures (face value of ₹ 100 each) of Exe Ltd., held as current assets:

1.4.2019	Opening balance – 12,500 debentures, cost ₹ 12,25,000
1.6.2019	Purchased 9,000 debentures @ ₹ 98 each ex-interest
1.11.2019	Purchased 12,000 debentures @ ₹ 115 each cum-interest
31.1.2020	Sold 13,500 debentures @ ₹ 110 each cum-interest
31.3.2020	Market value of debentures @ ₹ 115 each

Due dates of interest are 30th June and 31st December. Brokerage at 1% is to be paid for each transaction. Mr. Harsh closes his books on 31.3.2020.

Show investment account as it would appear in his books assuming FIFO method is followed.

Solution

Investment Account of Mr. Harsh for the year ending on 31-3-2020
(Scrip: 10% Debentures of Exe Limited)
(Interest Payable on 30th June and 31st December

Date	Particulars	Nom. Value	Interest	Cost	Date	Particulars	Nom. Value	Interest	Cost
1.4	To Balance b/d	12,50,000	31,250	12,25,000	30.06	By Bank 21,50,000X 10%X1/2	-	1,07,500	-
1.6	To Bank (W.N.1)	9,00,000	37,500	8,90,820	31.12	By Bank 33,50,000X 10%X1/2		1,67,500	
1.11	To Bank (W.N.2)	12,00,000	40,000	13,53,800	31.1	By Bank (W.N.3)	13,50,000	11,250	14,58,900

31.1	To Profit & Loss A/c (W.N.3)			1,34,920	31.3	By Balance c/d (W.N.4)	20,00,000	50,000	21,45,640
31.3	To Profit & Loss A/c (Bal. fig.)		2,27,500						
		33,50,000	3,36,250	**36,04,540**			**33,50,000**	3,36,250	**36,04,540**

Working Notes:

1. **Purchase of debentures on 1.6.19**

Interest element = 9,000 x 100 x 10% x 5/12 = ₹37,500

Investment element = (9,000 x 98) + [1%(9,000 x 98)] = ₹8,90,820

2. **Purchase of debentures on 1.11.2019**

Interest element = 12,000 x 100 x 10% x 4/12 = ₹40,000

Investment element = 12,000 X 115 X 101% less 40,000 = ₹13,53,800

3. Profit on sale of debentures as on 31.1.20

Particulars	**Amount**
Sales price of debentures (13,500 x ₹ 110)	14,85,000
Less: Brokerage @ 1%	(14,850)
	14,70,150
Less: Interest (1,35,000/ 12)	(11,250)
	14,58,900
Less: Cost of Debentures [(12,25,000 + (890820 X 1,00,000/9,00,000)]	(13,23,980)
Profit on sale	**1,34,920**

4. **Valuation of closing balance as on 31.3.2020:**

Market value of 20,000 Debentures at ₹115 = ₹23,00,000

Cost of	
8,000 Debentures	8,90,820/ 9,000 X 8,000 = 7,91,840
12,000 Debentures	= 13,53,800
Total	21,45,640

Value at the end is ₹ 21,45,640, i.e., which is less than market value of ₹23,00,000.

Variable Income Bearing Scrips / Securities (VIBS)

1) Original shares

No. of shares 100000
Face value 10
Issue Price 20

A

Inv. in Equity shares of X Ltd. A/c - Dr	1L X 20
To Bank A/c	1L X 20

X Ltd.

Bank A/c - Dr	1L X 20
To Equity share cap. A/c	1L X 10
To Securities Premium A/c	1L X 10

2) Bonus shares

: Shares issued free of cost

Original shares 100000
Bonus scheme 1 for every 2
Bonus shares = $1L \times \frac{1}{2}$ = 50000 shares

A

No Entry for Bonus Issue. Only no. of shares will increase which reduces cost/share

X Ltd.

Reserves & Surplus A/c - Dr	50000 X 10
To Equity share cap. A/c	50000 X 10

3) Right Shares : Offer given to existing shareholders to purchase shares at concessional rate. Shareholders can subscribe shares or they can sell their rights to outsiders.

Original shares = 100000

Right Issue = 1 for every 4 @ 15/share

Right shares = $1L \times \frac{1}{4}$ = 25000 shares

Ⓐ

Right Entitlement = 25000

Subscribe

15000 @ 15/sh.

Inv. in Eq. sh. - Dr 15000×15

To Bank A/c 15000×15

Sale of Rights

10000 @ 2/right

↓

20000 trfd. to P&L A/c as per PARA 13 of AS-13

X Ltd.

Bank A/c - Dr 25000 × 15

To Equity share cap. A/c 25000 × 10

To Securities Premium A/c 25000 × 5

Note: Person (B) purchasing right from A

Total Cost of Investment to B = 17 per share

2 paid to A

15 paid to X Ltd.

Inv. in Equity shares of X Ltd. A/c - Dr 10000 × 17

To Bank A/c 10000 × 17

Question

Smart Investments made the investments in Equity Shares of X Ltd:

01.04.2019	Opening: 2,000 Equity Shares at cost of 3,00,000
15.04.2019	Purchased 5,000 equity shares @ ₹ 200 per share Brokerage of 1% was paid in addition (Face Value of shares ₹10)
03.06.2019	The company announced a bonus issue of 2 shares for every 5 shares held.
16.08.2019	The company made a rights issue of 1 share for every 7 shares held at ₹ 250 per share. The entire money was payable by 31.08.2019.
22.08.2019	Rights to the extent of 20% was sold @ ₹ 60. The remaining rights were subscribed
02.09.2019	Dividend @ 15% for the year ended 31.03.2019 was received on 16.09.2019
15.12.2019	Sold 3,000 shares @ ₹ 300. Brokerage of 1% was incurred extra.
15.01.2020	Received interim dividend @ 15% for the year 2019-20
31.03.2020	The shares were quoted in the stock exchange @ ₹ 220

Prepare Investment A/cs in books of Smart Investments. Assume that average cost method is followed.

Solution

Investments in Equity shares of X Ltd. for year ended 31.3.2020

Date	Particulars	No.'s	Income	Amount	Date	Particulars	No.'s	Income	Amount
01.04	To Balance b/d	2,000		3,00,000	16.09	By Bank A/c (Dividend)	-	3,000	7,500
15.04	To Bank A/c	5,000	-	10,10,000	15.12	By Bank A/c	3,000	-	8,91,000
03.06	To Bonus Issue A/c	2,800	-	-	15.01	By Bank A/c (Interim dividend)	-	11,880	-
31.08	To Bank A/c	1,120	-	2,80,000	31.03	By Balance c/d	7,920	-	11,47,747
15.12	To P & L A/c-(Profit)	-	-	4,56,247					
31.03	To P & L A/c-Transfer	-	14,880	-					
		10,920	**14,880**	**20,46,247**			**10,920**	**14,880**	**20,46,247**

Working Notes:

1. **Cost of equity shares purchased on 15/4/2019** = Cost + Brokerage = (5,000 ×₹ 200) + 1% of (5,000 × ₹ 200) = ₹ 10,10,000
2. **Bonus shares** = $\frac{7,000}{5}$ x 2 = 2,800 shares
3. **Right shares** = $\frac{2,000 + 5,000 + 2,800}{7}$ x 1 = 1,400 shares

Shares subscribed = 1,400 * 80% = 1,120 shares

Value of right shares subscribed = 1,120 shares @ ₹ 250 per share = ₹ 2,80,000

Calculation of sale of right entitlement: (1,400 shares x 20%) x ₹ 60 per share = ₹ 16,800

Amount received from sale of rights will be credited to P & L A/c as per para 13 of AS 13 'Accounting for Investments'.

4. **Dividend received**

On Opening holding: 2,000 shares x ₹ 10 x 15% = ₹3,000 credited to Dividend Account

On shares purchased on 15th April, 2019 = 5,000 shares x ₹ 10 x 15% = ₹7,500 will be adjusted to Investment A/c

Note: It is presumed that no dividend is received on bonus shares & right shares.

5. **Sale proceeds of equity shares on 15/12/2019** = Sale price – Brokerage = (3,000 ×₹ 300) – 1% of (3,000 × ₹ 300) = ₹ 8,91,000.

6. **Profit on sale of shares on 15/12/2019** = Sales proceeds – Average cost

Sales proceeds = ₹ 8,91,000

Average cost = [(3,00,000 +10,10,000+2,80,000-7,500) × 3,000
10,920
= [15,82,500 × 3,000/10,920] = 4,34,753

Profit = ₹ 8,91,000 – ₹ 4,34,753=₹ 4,56,247.

7. **Amount of Interim Dividend =** (2,000+5,000+2,800+1,120-3,000) x 10 x 15% = 11,880

8. **Valuation of equity shares on 31st March, 2020**

Cost =₹ [15,82,500 × 7,920/10,920] = ₹ 11,47,747

Market Value = 7,920 shares ×₹ 220 =₹ 17,42,400

Closing stock of equity shares has been valued at ₹ 11,47,747 i.e. cost being lower than the market value.

Concept 3: Conversion of Debentures into Shares

Entry:

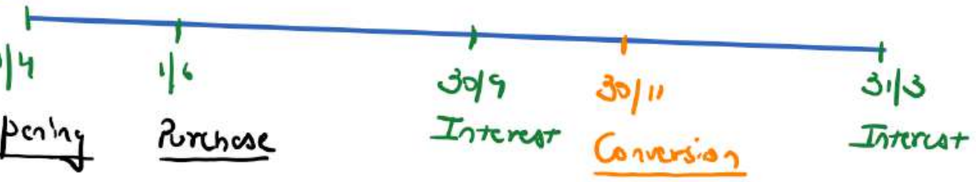
Investment in Equity Shares of Co. A/c – Dr ★
To Investment in __% Debentures of Co.

Amount★: Cost of Deb. converted will become cost of Equity shares Received.

Note: Interest on Debentures converted will be received at time of conversion.

Example:

12% Deb. of X Ltd.



	Opening	Purchase
Nom:	200000	100000
Cost:	240000	108000

20% Deb. converted
& 1000 Equity Shares received

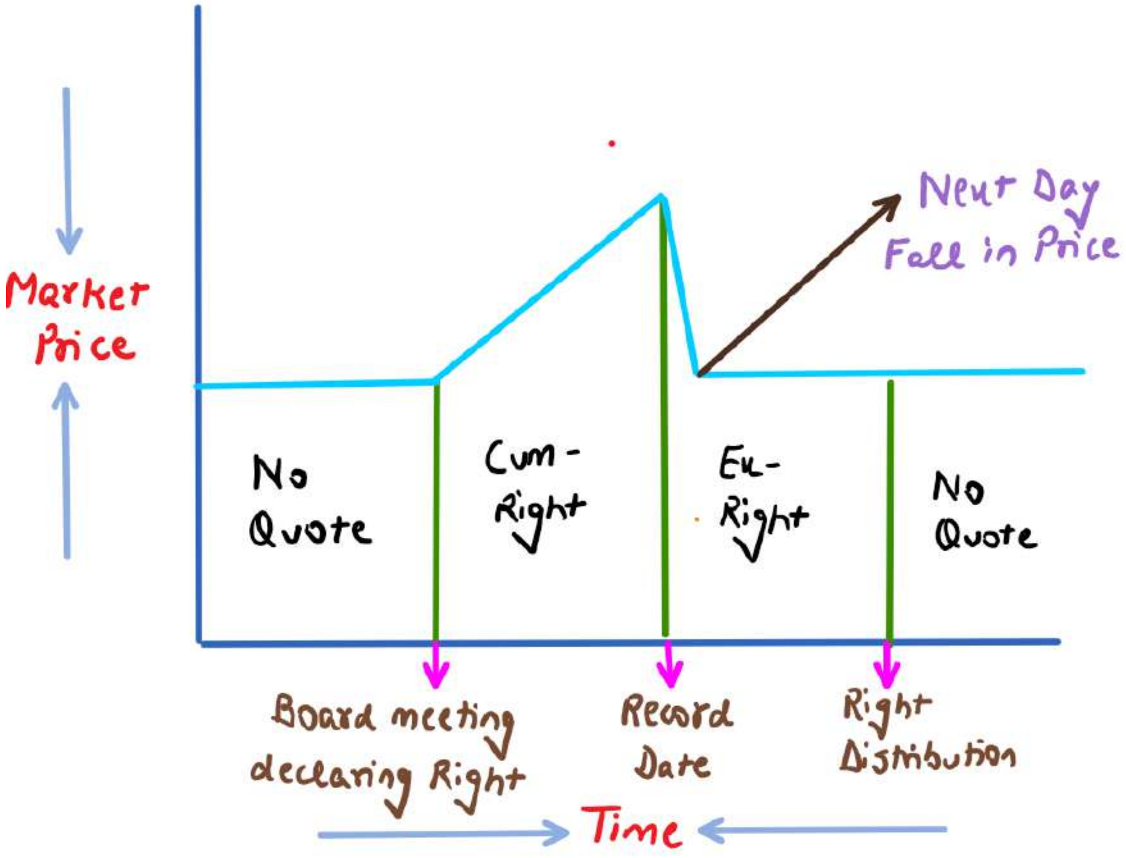
$$\text{Cost of Debentures converted} = \frac{(240000+108000)}{300000} \times \overset{3L \times 20\%}{60000} \Rightarrow 69600$$

Investment in Equity Shares of X Ltd. A/c – Dr 69600 (No. 1000)
To Investment in 12% Deb. of X Ltd. A/c 69600 (Nom. value 60000)

Interest Rec. on Conversion = $60000 \times 12\% \times \frac{2}{12} = 1200$

CUM RIGHT PURCHASE: (Exception to Para 13 of AS 13)

PARA 13 of AS 13: When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.



Example:

Cum Right Price of Share = 12000

Ex-Right Price of Share = 10000

So sale of right upto maximum of 2000 will be credited to Investment A/c. (Cost of Investment will reduce)

Any excess will be profit on sale of right. (Trfd. to P&L A/c)

Case 1: Right Sale = 3000 → 2000 Credited to Investment A/c; → 1000 credited / trfd. to P&L A/c

Case 2: Right Sale = 1500 → 1500 Credited to Investment A/c

AS 13: ACCOUNTING FOR INVESTMENTS

Meaning	Investments are assets held by an enterprise for: ✓ Earning income by way of dividends, interest, and rentals, ✓ Capital appreciation, or ✓ Other benefits to the investing enterprise. Note: Assets held as stock-in-trade are not 'investments'.	
Non Applicability	This Standard does not deal with: ❖ Bases for recognition of interest, dividends and rentals earned on investments which are covered by AS:9 on Revenue Recognition ❖ Operating or finance leases ❖ Investments of retirement benefit plans and life insurance enterprises ❖ mutual funds and venture capital funds and/or the related asset management companies, banks and public financial institutions	
Forms of Investments	→ Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). → For some investments, an active market exists from which a market value can be established. For such investments, market value generally provides the best evidence of fair value. For other investments, an active market does not exist and other means are used to determine fair value.	
Investment Properties	An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. *An enterprise holding investment properties should account for them in accordance with cost model as prescribed in AS 10,*	
Classification of Investments	Current Investment	It is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.
	Long Term Investment	It is an investment other than a current investment.
COST OF INVESTMENTS		
Direct Purchase	The cost of an investment includes acquisition charges such as brokerage, fees and duties.	
In exchange for share /Other Securities	Cost of Investment is ➢ Fair Market Value (FMV) of Securities issued or ➢ Fair Market Value (FMV) of the Investment acquired whichever is more clearly evident.	

CARRYING AMOUNT OF INVESTMENTS	
Current Investments	Lower of Cost and Fair value. Lower can be on Individual basis or category wise (i.e. equity shares, debentures, preference shares etc.) but not on global/overall basis. However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.
Long Term Investments	Usually Carried at cost. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the P&L A/c. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment.

RECLASSIFICATION OF INVESTMENTS	
Reclassified from Long Term to Current	Reclassified from Current to Long Term
Transfers are made at the lower of cost and carrying amount at the date of transfer	Transfers are made at the lower of cost and fair value at the date of transfer.

DISPOSAL OF INVESTMENTS
On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

Valuation of Investments

Example:

	Cost	Market/ Fair value	Lower
Inv. in Equity shares			
A1	50	60	50
A2	90	75	75
	140	135	125
Inv. in Mutual Funds			
MF1	30	25	25
MF2	40	48	40
	70	73	65
TOTAL	210	208	

A) Individual/Scrip wise

Equity Shares = 125
Mutual Funds = 65
190

B) Category wise

Equity Shares = 135
Mutual Funds = 70
205

C) Global Basis

Value = 208

AS 13: CASE STUDY QUESTIONS

Question 1 *(ICAI Study Material)*

M/s Innovative Garments Manufacturing Company Limited invested in the shares of another company on 1st October, 2021 at a cost of ₹ 2,50,000. It also earlier purchased Gold of ₹ 4,00,000 and Silver of ₹ 2,00,000 on 1st March, 2019. Market value as on 31st March, 2022 of above investments are as follows: Shares 2,25,000 Gold 6,00,000 Silver 3,50,000
How above investments will be shown in the books of accounts of M/s Innovative Garments Manufacturing Company Limited for the year ending 31st March, 2022 as per the provisions of Accounting Standard 13 "Accounting for Investments"?

Solution

As per AS 13 'Accounting for Investments', for investment in shares - if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (₹ 2,50,000) and market value (₹ 2,25,000) as on 31 March 2022, i.e., ₹ 2,25,000.
If equity shares are acquired with an intention to hold for long term period (more than one year), then should be considered as long-term investment to be shown at cost in the Balance Sheet of the company. However, provision for diminution should be made to recognise a decline, if other than temporary, in the value of the investments.
Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 1st March, 2019) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31st March, 2022, i.e., ₹ 4,00,000 and ₹ 2,00,000 respectively, though their market values have been increased.

Question 2

X Ltd. had made an investment of ₹ 500 lakhs in the equity shares of Y Ltd. on 10.01.2023. The realisable value of such investment on 31.03.2023 became ₹ 200 lakhs as Y Ltd. lost a case of patent rights. Rose Ltd. follows financial year as accounting year. How will you recognize this reduction in financial statements for the year 2022-23.

Solution

Recognition of reduction in value of investment would depend upon the nature of investment and nature of decline as per Accounting Standard 13 "Accounting for Investments".
As per provisions of the standard, if the investments were acquired for long term and decline is temporary in nature, reduction in value will not be recognized and investments would be carried at cost. If the decline is of permanent nature, it will be charged to profit and loss account.
If the investments are current investments, then the reduction should be recognized and charged to Profit and Loss Account as the current investments are carried at cost or fair value, whichever is less.

Question 3 *(ICAI Study Material)*

An unquoted long-term investment is carried in the books at cost of ₹ 2 lacs. The published accounts of unlisted company received in May, 2021 showed that the company has incurred cash losses with decline market share and the long-term investment may not fetch more than ₹ 20,000. How you will deal with it in preparing the financial statements of investing company for the year ended 31.3.2021?

Solution

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2021.

Question 4 *(Inter Dec 2021) (5 Marks)*

Mr. Mohan has invested some money in various Mutual funds. Following information in this regard is given:

Mutual Funds	Date of purchase	Purchase cost (₹)	Brokerage Cost (₹)	Stamp duty (₹)	Market value as on 31.03.2021 (₹)
A	01.05.2017	50,000	200	20	48,225
B	05.08.2020	25,000	150	25	24,220
C	01.01.2021	75,000	300	75	78,190
D	07.05.2020	70,000	275	50	65,880

You are required to:

a) Classify his investment in accordance with AS-13 (revised).

b) Value of Investment in mutual fund as on 31.03.2021

Solution

As per AS 13, a current investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made. The carrying amount for current investments is the lower of cost and fair value.

A long-term investment is an investment other than a current investment. Long term investments are usually carried at cost. If there is a decline, other than temporary, in the value of a long-term investment; the carrying amount is reduced to recognize the decline.

Mutual Funds	Classification	Cost (₹)	Market value (₹)	Carrying value (₹)
A	Long-term Investment	50,220	48,225*	50,220
B	Current Investment	25,175	24,220	24,220
C	Current Investment	75,375	78,190	75,375
D	Current Investment	70,325	65,880	65,880
Total				2,15,695

Note: *The reduction in value of Mutual fund A is considered to be temporary. If reduction in Market value is assumed as other than temporary, then carrying value of ₹48,225 will be considered.

Question 5 *(Inter Jan 2021) (5 Marks)*

Kunal Securities Ltd. wants to reclassify its investments in accordance with AS-13 (Revised). State the values, at which the investments have to be reclassified in the following cases:

(i) Long term investment in Company A, costing ₹ 10.5 lakhs is to be re-classified as current investment. The company had reduced the value of these investments to ₹ 9 lakhs to recognize a permanent decline in value. The fair value on the date of reclassification is ₹ 9.3 lakhs.

(ii) Long term investment in Company B, costing ₹ 14 lakhs is to be re-classified as current investment The fair value on the date of reclassification is ₹ 16 lakhs and book value is ₹ 14 lakhs.

(iii) Current investment in Company C, costing ₹ 12 lakhs is to be re-classified as long term investment as the company wants to retain them. The market value on the date of reclassification is ₹ 13.5 lakhs.

(iv) Current investment in Company D, costing ₹ 18 lakhs is to be re-classified as long term investment. The market value on the date of reclassification is ₹ 16.5 lakhs.

Solution

As per AS 13 (Revised) 'Accounting for Investments', where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer. And where investments are reclassified from current to long term, transfers are made at lower of cost and fair value on the date of transfer.

Accordingly, the re-classification will be done on the following basis:

(i) In this case, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at ₹ 9 lakhs in the books.

(ii) The carrying / book value of the long-term investment is same as cost i.e., ₹ 14 lakhs. Hence this long-term investment will be reclassified as current investment at book value of ₹ 14 lakhs only.

(iii) In this case, reclassification of current investment into long-term investments will be made at ₹ 12 lakhs as cost is less than its market value of ₹ 13.5 lakhs.

(iv) Market value of the investment is ₹ 16.5 lakhs, which is lower than its cost i.e., ₹ 18 lakhs. Therefore, the transfer to long term investments should be done in the books at the market value i.e., ₹ 16.5 lakhs.

Question 6 *(Inter May 2019) (5 Marks)*

On 15th June, 2021, Y limited wants to re-classify its investments in accordance with AS 13 (revised). Decide and state the amount of transfer, based on the following information:

1) A portion of long term investments purchased on 1st March, 2020 are to be reclassified as current investments. The original cost of these investments was ₹ 14 lakhs but had been written down by ₹ 2 lakhs (to recognise 'other than temporary' decline in value). The market value of these investments on 15th June, 2021 was ₹ 11 lakhs.

2) Another portion of long term investments purchased on 15th January, 2020 are to be re-classified as current investments. The original cost of these investments was ₹ 7 lakhs but had been written down to ₹ 5 lakhs (to recognize 'other than temporary' decline in value). The fair value of these investments on 15th June, 2021 was ₹ 4.5 lakhs.

3) A portion of current investments purchased on 15th March, 2021 for ₹ 7 lakhs are to be re-classified as long term investments, as the company has decided to retain them. The market value of these investments on 31st March, 2021 was ₹ 6 lakhs and fair value on 15th June 2021 was ₹ 8.5 lakhs,

4) Another portion of current investments purchased on 7th December, 2020 for ₹ 4 lakhs are to be re-classified as long term investments. The market value of these investments was: on 31st March, 2021 ₹ 3.5 lakhs on 15th June, 2021 ₹ 3.8 lakhs

Solution

As per AS 13 (Revised) 'Accounting for Investments', where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer; and where investments are reclassified from current to long term, transfers are made at lower of cost and fair value on the date of transfer. Accordingly, the re-classification will be done on the following basis:

1) In this case, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at ₹ 12 lakhs in the books.
2) In this case also, carrying amount of investment on the date of transfer is less than cost; hence this re-classified current investment should be carried at ₹ 5 lakhs in the books.
3) In this case, reclassification of current investment into long-term investments will be made at ₹ 7 lakhs as cost is less than its fair value of ₹ 8.5 lakhs on the date of transfer.
4) In this case, market value (considered as fair vale) is ₹ 3.8 lakhs on the date of transfer which is lower than the cost of ₹ 4 lakhs. The reclassification of current investment into long-term investments will be made at ₹ 3.8 lakhs.

BORROWING COSTS

Objective	✓ The objective is accounting for borrowing costs. It does not deal with the actual or imputed cost of owner's equity including preference share capital not classified as liability.
Meaning	✓ These are the interest and other costs incurred by an enterprise in connection with the borrowing of funds.
Inclusions	✓ It includes the following: ❖ Interest & related charges on bank borrowings (short term & long term) ❖ amortization of discounts or premiums relating to borrowings ❖ amortization of ancillary costs incurred ❖ finance charges in respect of assets acquired under finance leases ❖ exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Capitalisation of Borrowing Costs
Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.
Borrowing cost on any item other than the qualifying asset should be written off in the P&L A/c in the period in which they are incurred.
To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the *actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.*
In respect of general borrowings, the amount of borrowing costs eligible for capitalisation should be determined by applying a *capitalisation rate* to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

QUALIFYING ASSETS

Meaning	✓ A qualifying asset is an asset (tangible or intangible) that necessarily takes a substantial period of time to get ready for its intended use or sale.
Substantial Period	✓ Substantial period of time depends on the facts & circumstances of each case. However, a period of 12 months may be considered a substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case
Inclusions	✓ Following assets take >= 12 months to get ready to use : ❖ Assets that are constructed for own use of enterprise like manufacturing plants, power generation facilities, etc. ❖ Inventories where time is major factor to bring a change in their condition e.g. Liquor & Timber ❖ Investment Properties (Building meant for capital appreciation and earning rental income)
Exclusions	✓ Assets that are ready for intended use when acquired are not qualifying asset.

COMMENCEMENT OF CAPITALISATION

The capitalisation of borrowing costs should commence when all the following conditions are satisfied:

- expenditure for acquisition, construction or production of a qualifying asset is being incurred
- borrowing costs are being incurred
- activities that are necessary to prepare the asset for its intended use or sale are in progress.

SUSPENSION OF CAPITALISATION

General Rule	✓ Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.
Exception	✓ Capitalisation of borrowing costs is not normally suspended during period when substantial technical and administrative work is being carried out. ✓ When a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example: Capitalisation continues during extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during construction period in the geographic region involved.

CESSATION OF CAPITALISATION

- Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
- An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete
- Construction in Parts: When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities of that part are complete.

DISCLOSURE REQUIREMENTS

The financial statements should disclose:

- the accounting policy adopted for borrowing costs
- the amount of borrowing costs capitalised during the period.

Question 1 *(Inter May 2019) (5 Marks)* *Pg no._____*

First Ltd. began construction of a new factory building on 1st April, 2021. It obtained ₹ 2,00,000 as a special loan to finance the construction of the factory building on 1st April, 2021 at an interest rate of 8% per annum. Further, expenditure on construction of the factory building was financed through other non-specific loans.

Details of other outstanding non-specific loans were:

Amount	Rate of Interest p.a.
4,00,000	9%
5,00,000	12%
3,00,000	14%

The expenditures that were made on the factory building construction were as follows:

Date	Amount
1st April, 2021	3,00,000
31st May, 2021	2,40,000
1st August, 2021	4,00,000
31st December, 2021	3,60,000

The construction of factory building was completed by 31st March, 2022.

As per the provisions of AS 16, you are required to:

(1) Calculate the amount of interest to be capitalized.

(2) Pass Journal entry for capitalizing cost & borrowing cost in respect of factory building

Solution

Computation of average accumulated expenses

3,00,000 x 12 / 12	3,00,000
2,40,000 x 10/ 12	2,00,000
4,00,000 x 8 / 12	2,66,667
3,60,000 x 3 / 12	90,000
	8,56,667

Calculation of average interest rate other than for specific borrowings

Amount of loan	Rate of Interest	Amount of interest
4,00,000	9%	36,000
5,00,000	12%	60,000
3,00,000	14%	42,000
12,00,000		1,38,000
Weighted average rate of interest {(1,38,000/ 12,00,000) x 100}		11.50%

Interest on average accumulated expenses

Specific borrowings (₹ 2,00,000 x 8%)	16,000
Non-specific borrowings (₹ 6,56,667* x 11.50%)	75,517
Amount of interest to be capitalized	91,517

*(₹ 8,56,667 – ₹ 2,00,000)

Total expenses to be capitalized for building

Cost of building ₹(3,00,000+2,40,000+4,00,000+3,60,000)	13,00,000
Add: Amount of interest to be capitalized	91,517
	13,91,517

Journal Entry

Date	Particulars	L.F.	Dr.	Cr.
31.03.2022	Building account Dr.		13,91,517	
	To Building WIP A/c*			13,00,000
	To Borrowing Costs A/c			91,517
	(Being amount of cost of building and borrowing cost thereon capitalized)			

*Considering that ₹ 13,00,000 was debited to Building WIP A/c earlier.

Question 2 *(Inter May 2023) (5 Marks)* *Pg no._____*

On 1st April, 2022 Workhouse Limited took a loan from a Financial Institution for ₹ 25,00,000 for the construction of Building. The rate of interest is 12%.

In addition to above loan, the company has taken multiple borrowings as follows:

(a) 8% Debentures	₹ 15,00,000
(b) 15% Term Loan	₹ 30,00,000
(c) 10% Other Loans	₹ 18,00,000

The company has utilised the above funds in construction/purchase of the following assets:

(a) Building	₹ 70,00,000
(b) Furniture	₹ 22,00,000
(c) Plant & Machinery	₹ 90,00,000
(d) Factory Shed	₹ 43,00,000

The construction of Building, Plant & Machinery and Factory Shed was completed on 31st March 2023. Readymade Furniture was purchased directly from the market. The factory was ready for production on 1 April 2023.

You are required to calculate the borrowing cost for both qualifying and non-qualifying assets.

Solution:

Interest to be Capitalized (on qualifying asset)

	Particulars	Computation	₹
i.	On specific Borrowings	25,00,000x12%	3,00,000
ii.	On non-specific borrowings	(W.N.1)	6,67,500
iii.	Amount of interest to be Capitalised	(i+ii)	9,67,500

Interest transferred to P&L (on non-qualifying asset)

	Particulars	Computation	₹
i.	On non-specific Borrowings	(W.N.1)	82,500

Working note:

1. Treatment of interest under AS 16 on non-specific borrowings

	Particulars	Qualifying asset	# Computation	Interest- Capitalized	Interest- charged to P&L A/c
i.	Building	Yes	45,00,000/2,00,00,000 x 63,00,000 x 11.9048%	1,68,750	-
ii.	Furniture	No	22,00,000/2,00,00,000 x 63,00,000 x 11.9048%	-	82,500

iii.	Plant & Machinery	Yes	90,00,000/2,00,00,000 x 63,00,000 x 11.9048%	3,37,500	-
iv.	Factory shed	Yes	43,00,000/2,00,00,000 x 63,00,000 x 11.9048%	1,61,250	-
	Total			6,67,500	82,500

Note: Alternative manner of presentation for Treatment of interest under AS 16 on non-specific borrowings:

	Particulars	Qualifying asset	Expenses Incurred ₹	Share in borrowings ₹	Interest-Capitalized ₹	Interest-charged to P&L A/c ₹
i.	Building	Yes	45,00,000	7,50,000 x 45/200	1,68,750	-
ii.	Furniture	No	22,00,000	7,50,000 x 22/200	-	82,500
iii.	Plant & Machinery	Yes	90,00,000	7,50,000 x 90/200	3,37,500	-
iv.	Factory shed	Yes	43,00,000	7,50,000 x 43/200	1,61,250	-
	Total		2,00,00,000		6,67,500	82,500

2. Weighted Average interest rate for non-specific borrowings

Particulars	Amount of loan (a)	Rate of interest (b)	Amount of interest (c) = (a) x (b)
Debentures	15,00,000	8%	1,20,000
Term loan	30,00,000	15%	4,50,000
Other loans	18,00,000	10%	1,80,000
	63,00,000		7,50,000
	# Weighted Average Rate of Interest = 7,50,000 / 63,00,000 x 100 = 11.9048%		

Question 3 *(RTP May 2023)* *Pg no._____*

Expert Limited issued 12% secured debentures of ₹ 100 lakhs on 01.06.2021. Money raised from debentures to be utilized as under:

Intended Purpose	Amount (₹ in lakhs)
Construction of factory building	40
Purchase of Machinery	15
Working Capital	30
Purchase of Furniture	2
Purchase of Truck	13

Additional Information:

(i) Interest on debentures for the Financial Year 2021-2022 was paid by the Company.

(ii) During the year, the company invested idle fund of ₹ 5 lakhs (out of the money raised from debentures) in Bank's fixed deposit and earned interest of ₹ 50,000.

(iii) In March, 2022 construction of factory building was not completed (it is expected that it will take another 6 months).

(iv) In March 2022, Machinery was installed and ready for its intended use.

(v) Furniture was put to use at the end of March 2022.

(vi) Truck is going to be received in April, 2022.

You are required to show the treatment of interest as per AS 16 in respect of borrowing cost for the year ended 31st March, 2022 in the Books of Expert Limited.

Solution

Particulars	Nature of assets	Interest to be Capitalized	Interest to be charged to P&L A/c
Construction of factory building	Qualifying Asset	9,50,000x40/100 = 3,80,000	Nil
Purchase of Machinery	Not a Qualifying Asset	Nil	9,50,000x15/100 = 1,42,500
Working Capital	Not a Qualifying Asset	Nil	9,50,000x30/100 = 2,85,000
Purchase of Furniture	Not a Qualifying Asset	Nil	9,50,000x2/100 = 19,000
Purchase of Truck	Not a Qualifying Asset	Nil	9,50,000x13/100 = 1,23,500
		3,80,000	5,70,000

Notes:

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

a) Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale; whereas,

b) Non-qualifying asset is an asset which is ready for its intended use or sale at the time of its acquisition.

c) As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets should be capitalized as part of the cost of that asset. Other borrowing costs are recognized as expense in the period in which they are incurred.

d) It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost = ₹ 10,00,000 (100 lakhs x 12% x 10/12) – ₹ 50,000 = ₹ 9,50,000

Question 4 (RTP Nov 2020) (Similar) / (ICAI Study Material) Pg no.______

Rainbow Limited borrowed an amount of ₹ 150 crores on 1.4.2021 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized ₹ 19.50 crores for the accounting period ending on 31.3.2022. Due to surplus fund out of ₹ 150 crores, income of ₹ 3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant AS.

Solution

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

The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. Hence, in the above case, treatment of accountant of Rainbow Ltd. is incorrect. The amount of borrowing costs capitalized for the financial year 2021-2022 should be calculated as follows:

	₹ in crores
Actual Interest for 2021-22 (11% of 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 2021-22	13.00

Question 5 *(ICAI Study Material)* *Pg no._____*

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2021-22. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹ 50 lakhs.
As on 31st March, 2022, since the said project was not complete, the directors of Take Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment

Solution

Cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.
Further, as per AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 2022.

Question 6 *(RTP May 2018) / (RTP Nov 2019) / (RTP Nov 2021)* *Pg no._____*

In May, 2021, Capacity Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2022 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was ₹ 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2022 amounted to ₹ 25 lakhs.
Can ₹ 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building? Explain the treatment in line with the provisions of AS 16.

Solution

According to AS 16 ‘Borrowing Costs’, capitalisation of borrowing costs should cease when substantially all the activities to prepare the qualifying asset for its intended use or sale are completed.
In the given case, since the qualifying asset was ready to use in January, 2022, therefore, interest till that date can only be capitalized. Hence, interest of ₹ 18 lakhs will only be capitalized. The balance of ₹ 7 lakhs (i.e. 25-18) will be debited to Profit and Loss Account.

Question 7 *(ICAI Study Material)* *Pg no._____*

On 1st April, 2021, Amazing Construction Ltd. obtained a loan of ₹ 32 crores to be utilized as:-

S. No.	Particulars	Amount (in ₹)
1.	Construction of sealink across two cities:(work was held up totally for a month during the year due to high water levels)	25 crores
2.	Purchase of equipments and machineries	3 crores
3.	Working capital	2 crores
4.	Purchase of vehicles	50 Lakhs
5.	Advance for tools/cranes etc	50 Lakhs
6.	Purchase of technical know-how	1 crore
7.	Total interest charged by bank for year ending 31st March, 2022	80 Lakhs

Show the treatment of interest by Amazing Construction Ltd.

Solution

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

Particulars	Whether Q.A.	Interest to be capitalized	Interest to be charged to P&L A/c
Construction of sealink across 2 cities	Yes	80,00,000*25/32= 62,50,000	
Purchase of equipments & machineries	No		80,00,000*3/32= 7,50,000
Working capital	No		80,00,000*2/32= 5,00,000
Purchase of vehicles	No		80,00,000*0.5/32= 1,25,000
Advance for tools/cranes etc	No		80,00,000*0.5/32= 1,25,000
Purchase of technical know-how	No		80,00,000*1/32= 2,50,000
		62,50,000	17,50,000

Notes:

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

e) Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale; whereas,

f) Non-qualifying asset is an asset which is ready for its intended use or sale at the time of its acquisition.

g) As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets should be capitalized as part of the cost of that asset. Other borrowing costs are recognized as expense in the period in which they are incurred.

h) It is assumed that work held up for a month due to high water level is normal during the construction of sealink and capitalization of borrowing cost should not be suspended for necessary temporary delay.

Question 8 - *(ICAI Study Material)* *Pg no._____*

H Ltd. incurs borrowing costs for the purpose of construction of a qualifying asset for its own use. The construction gets completed on May 31, 2023. However, decoration work is under process which is expected to be completed by November 2023 after which H Ltd. will be able to start using the said asset for its own use. H Ltd. wants to capitalize the eligible borrowing costs incurred up to November 2023.

Solution:

The capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale is completed.

In the given case, H Ltd. should capitalize borrowing costs only up to May 31, 2023. The borrowing cost incurred thereafter cannot be capitalized as the asset was ready for its intended use on May 31, 2023. The fact that decoration work was being carried out should not be considered as the asset was ready for its intended use on May 31, 2023

Question 9 *(ICAI Study Material)* *Pg no._____*

ABC Ltd. is in the process of getting an entertainment park constructed. For this purpose, it has taken loan from a bank. The said park consists of several rides and facilities, each of which can be used individually. Three fourth part of the park has been constructed and can be opened up for public, while construction on the remaining part is continuing. Whether the capitalization of borrowing cost should continue for whole park until construction continues?

Solution:

ABC Ltd. is in process of constructing an entertainment park which consists of several rides and facilities that can operate independently for their intended use. Even though the park as whole is not complete, the individual facilities are ready for their intended use.

The cessation of capitalization depends upon the nature of the qualifying assets, particularly where the qualifying assets consists of various parts. There are qualifying assets where each part is capable of being used while the construction continues on other parts. There are qualifying assets where all parts have to be completed before any earlier completed part can be put to use.

Since in the given scenario, the individual facilities are capable of operating independently and are ready for their intended use, therefore the borrowing costs shall cease to be capitalized for the three-fourth part of the project.

Question 10 *(RTP Nov 2022) / (ICAI Study Material)* *Pg no._____*

Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the building will be started as soon as they are completed.

Following is the detail of the work done on different phases of the building during the current year: (₹ in lakhs)

	Phase I	Phase II	Phase III	Phase IV
	₹	₹	₹	₹
Cash expenditure	10	30	25	30
Building purchased	24	34	30	38
Total expenditure	34	64	55	68
Total expenditure of all phases				221
Loan taken @ 15% at the beginning of the year				200

During mid of the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year.

Solution:

	Particulars	₹
1.	Interest expense on loan ₹ 2,00,00,000 at 15%	30,00,000
2	Total cost of Phases I and II (₹ 34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (₹ 55,00,000 + ₹ 68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate Loan amount = (30,00,000*98,00,000)/2,21,00,000 =	13,30,317 (approx.)
7.	Interest on loan used for Phases III & IV, based on proportionate Loan amount	16,69,683 (approx.)

Accounting Treatment:

1. For Phase I and Phase II

   Since Phase I and Phase II have become operational at the mid of the year, half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be expensed during the year.

2. For Phase III and Phase IV

   Interest of ₹ 16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

Question 11 *(RTP May 2023)*

Pg no._____

ABC Builders Limited had borrowed a sum of US $ 15,00,000 at the beginning of Financial year 2021-22 for its residential project at London Interbank Offered Rate (LIBOR) + 4 %. The interest is payable at the end of the Financial Year. At the time of availing the loan, the exchange rate was ₹ 72 per US $ and the rate as on 31st March, 2022 was ₹ 76 per US $. If ABC Builders Limited borrowed the loan in Indian Rupee equivalent, the pricing of loan would have been 9.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2022 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

Solution

(i) Interest for the period 2021-22 = US $ 15 lakhs x 5% × ₹ 76 per US $ = ₹ 57 lakhs

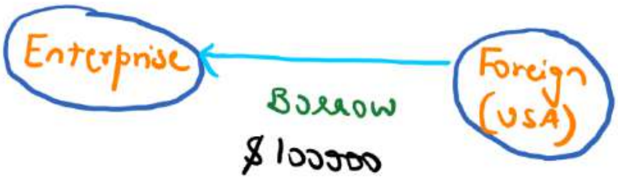
(ii) Increase in liability towards principal amount = US $ 15 lakhs × ₹ (76 - 72) = ₹ 60 lakhs.

(iii) Interest that would have resulted if the loan was taken in Indian currency = US $ 15 lakhs × ₹ 72 x 9.5% = ₹ 102.6 lakhs

(iv) Difference between interest on local currency borrowing and foreign currency borrowing= ₹ 102.6 lakhs - ₹ 57 lakhs = ₹ 45.6 lakhs.

Therefore, out of ₹ 60 lakhs increase in the liability towards principal amount, only ₹ 45.60 lakhs will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 102.60 lakhs being the aggregate of interest of ₹ 57 lakhs on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 45.60 lakhs. Hence, ₹ 102.60 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining ₹ 14.4 lakhs (60 - 45.60) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

FOREIGN BORROWING



When loan taken ER 1$ = ₹50

Year End ER 1$ = ₹55

Interest on foreign borrowing = 1000000 (Capitalised) (Given)

Exchange Difference (1L X 5) = 500000

	I	II	III
Interest on Local Borrowing (Notional)	1200000	1800000	900000
Exchange Difference:			
Considered as Borrowing cost [Capitalised : AS16]	12L-10L=2L	5L	Nil
Considered as Exchange Difference [P&L A/c : AS 11]	3L	Nil	5L
Total Amount capitalised	10L+2L=12L	10L+5L=15L	10L

Borrowing Costs (AS-16)

Meaning

- Interest costs
- Amortisation of premium or discount related to borrowing
- Amortisation of Ancillary costs
- Exchange Differences
  - Interest on Local Borrowings
  - (-) Interest on Foreign Borrowings

Recognition

Qualifying Asset

Substantial period of time to get ready for use/sale [>12M]

↓

Capitalise

Others

Ready for intended use when acquired (w/off in period in which incurred)

↓

P&L A/c

Commencement of Capitalisation

↓

Expenditure Incurred [Acquisition, construction or Production of Qualifying Asset]

+

Borrowing costs Incurred

+

Activities in Progress

Borrowing costs eligible for capitalisation

Specific Borrowing

Actual Borrowing costs
(-) Income from temporary Inv.

General Borrowing

Steps for capitalisation:

1) Weighted Average Expenditure
Expenditure X Period

2) Capitalisation Amount
a) Use specific borrowing first
b) Use General borrowing for balance
Amount = Expenditure X capitalisation Rate

Suspension of capitalisation

When active development Interrupted

Exception:

Substantial technical/admin work carried out,
Temporary delay part of process,
Unavoidable reasons, etc.

Cessation of capitalisation

When substantially all the activities are compleete

Notes:

- Amount capitalised cannot exceed borrowing costs
- Different rates for all specific borrowings
- Single rate for general borrowings

AS 17
Segment Reporting

Types

- Business Segment
  - Based on Products
- Geographical Segment
  - Based on Area

Segment Identification

Done by Management based on Organizational & management structure and internal reporting system in entity

Dominant Risk	Primary	Secondary
Product	Bus.	Geog.
Area	Geog.	Bus.
Both	Bus./Geog.	-
None	Bus.	Geog.

Identification of Reportable Segment

- Limits Method (Materiality Test)
  - ANY
    - Segment Revenue ≥ 10% of Total Segment Revenue
    - Segment Result ≥ 10% of Total Segment P/L ↑ (In Absolute terms)
    - Segment Assets ≥ 10% of Total Segment Assets
- Comparitive Method
  - (Qualify Limit Last year)
- Choice Method
  - (Management)

NOTE: Selected Reportable segments should represent 75% of external sales. If limit not attained then select further segments. (Overall Test)

Business Segment : Distinguishable component of business having separate risks & rewards in comparison to other segments. Such segments are broadly based on products.

Basis :	Example
1) Products	: Silk, cotton, wool, etc.
2) Production Process	: Handmade silk, Machine made silk, etc.
3) Distribution Process	: Retailers, Wholesalers, Direct to home, etc.
4) Customers	: Industrial, Domestic (End consumers), etc.

Geographical Segment : Distinguishable component of business having separate risks & rewards in comparison to other segments. Such segments are broadly based on Area.

Basis :	Example
1) Area	: North, South, East, West, etc.
2) Economic Environment	: Asia, Europe, USA, etc.
3) Currency	: Rupees, Dollars, Pounds, etc.
4) Political Boundaries	: India, Pakistan, Sri Lanka, etc.

Segment Report

Primary

1) Segment Revenue
2) Segment Result
3) Segment Assets
4) Segment Liabilities
5) Segment Fixed Assets acquired during period
6) Depreciation & Amortization
7) Non cash expense other than Depreciation & Amortization

Secondary

1) Segment Revenue
2) Segment Assets
3) Segment Fixed Assets acquired during period

(Reporting of only those segments which fulfill 10% criterion)

Reportable Segment
(Limits)

1) Revenue Based
(Seg. Rev. ≥ 10% of Total Seg. Rev.)

S.No.	Revenue	Reportable
A	600	
B	500	
C	200	
D	120	
E	80	

2) Result Based ie. Profit/(Loss)
(Seg. Result ≥ 10% of Total Seg. Profit/Loss w.e. is ↑)

S.No.	Result	Reportable
A	550	
B	450	
C	(95)	
D	100	
E	(135)	

3) Assets Based
(Seg. Assets ≥ 10% of Total Seg. Assets)

S.No.	Assets	Reportable
A	700	
B	800	
C	100	
D	150	
E	250	

Segment Revenue

Segment External Sales	xx
+ Apportioned Sales	xx
+ Inter Segment Sales	xx
	xx

Does not Include

★ Extraordinary Item

★ Interest/Dividend Income

★ Gain on Sale of Investment

Segment Expense

Segment Direct Expenses	xx
+ Apportioned Expenses	xx
+ Inter segment Expense	xx
	xx

Does not Include

★ Extraordinary Item

★ Interest Expense

★ Income Tax Expense

★ Administrative & HO Expenses

Segment Assets

Segment Fixed Assets
+ Segment Current Assets
(Directly Attributable + Allocated)

Does not Include

★ Income Tax Assets

★ Assets used for HO purpose

Segment Liabilities

Segment operating Liabilities
(Directly Attributable + Allocated)

Does not Include

★ Income Tax Liabilities

★ Borrowings & other Liabilities for financing

NOTE: Segment Result = Segment Revenue - Segment Expenses

Disclosure: Inter segment transfers should be measured on the basis that enterprise actually used to price those transfers. Basis of pricing inter segment transfers & any change therein should be disclosed in the financial statements.

Segment Report (Format)

Particulars	S1	S2	S3	Pending Segments	Total
1) Segment Revenue	xx	xx	xx	xx	xx
− Inter segment sales					(xx)
					xx
2) Segment Result	xx	xx	xx	xx	xx
± Unallocated Items					xx
Profit / (Loss)					xx
3) Segment Assets	xx	xx	xx	xx	xx
+ unallocated Assets					xx
					xx
4) Segment Fixed Assets Acquired	xx	xx	xx	xx	xx
5) Segment Liabilities	xx	xx	xx	xx	xx
+ Unallocated Liabilities					xx
					xx
6) Depreciation & Amortization	xx	xx	xx	xx	xx
7) Non cash expenses	xx	xx	xx	xx	xx

SEGMENT REPORTING

Question 1 *(Inter Jan 2021) (5 Marks)* Pg no._____

The Senior Accountant of AMF Ltd. gives the following data regarding its five segments:

Division	P	Q	R	S	T	Total
Segment Assets	80	30	20	20	10	160
Segment Result	(190)	10	10	(10)	30	(150)
Segment Revenue	620	80	60	80	60	900

The Senior Accountant is of the opinion that segment "P" alone should be reported. Is he justified in his view? Examine his opinion in the light of provision of AS-17 'Segment Reporting'.

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

a) Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

b) Its segment result whether profit or loss is 10% or more of:
   The combined result of all segments in profit; or
   The combined result of all segments in loss, whichever is greater in absolute amount; or

c) Its segment assets are 10% or more of the total assets of all segments.

Accordingly,

(a) On the basis of revenue from sales criteria, segment P is a reportable segment.

(b) On the basis of the result criteria, segments P & T are reportable segments (since their results in absolute amount is 10% or more of 200 Lakhs).

(c) On the basis of asset criteria, all segments except T are reportable segments.

Since all the segments are covered in at least one of the above criteria, all segments have to be reported upon in accordance with AS 17. Hence, the opinion of chief accountant that only segment 'P' is reportable is wrong.

Question 2 *(Inter May 2022) (5 Marks) / (ICAI Study Material)* Pg no._____

XYZ Ltd. has 5 business segments. Profit / Loss of each of the segments for the year ended 31st March,2022 has been provided below. You are required to identify from the following whether reportable segments or not reportable segments, on the basis of "profitability test" as per AS-17.

Segment	Profit (Loss) ₹ in lakhs
A	225
B	25
C	(175)
D	(20)
E	(105)

Solution

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

Its segment results whether profit or loss is 10% or more of:

(i) The combined result of all segments in profit; i.e. ₹ 250 Lakhs or
(ii) The combined result of all segments in loss; i.e. ₹ 300 Lakhs
whichever is greater in absolute amount i.e. ₹ 300 Lakhs.

Operating Segment	Absolute amount of Profit or Loss (₹ In lakhs)	Reportable Segment Yes or No
A	225	Yes
B	25	No
C	175	Yes
D	20	No
E	105	Yes

On the basis of the profitability test (result criteria), segments A, C and E are reportable segments (since their results in absolute amount is 10% or more of ₹ 300 lakhs i.e. 30 lakhs).

Question 3 *(ICAI Study Material)* Pg no.______

Heavy Goods Ltd. has 6 segments namely L-Q (below). The total revenues (internal and external), profits or losses and assets are set out below:

Segment	Inter Segment Sales	External Sales	Profit/ (Loss)	Total Assets
L	4,200	12,300	3,000	37,500
M	3,500	7,750	1,500	23,250
N	1,000	3,500	(1,500)	15,750
O	0	5,250	(750)	10,500
P	500	5,500	900	10,500
Q	1,200	1,050	600	5,250
	10,400	35,350	3,750	1,02,750

Heavy Goods Ltd. needs to determine how many reportable segments it has. You are required to advice Heavy Goods Ltd. as per the criteria defined in AS 17.

Solution

Quantitative Threshold Test:

Revenue Test:

Combined total sales of all the segment = ₹ 10,400 + ₹ 35,350 = ₹ 45,750.
10% thresholds = 45,750 x 10% = 4,575.

Profitability Test:

In the given situation, combined reported profit = ₹ 6,000 and combined reported loss (₹ 2,250). Hence, for 10% thresholds ₹ 6,000 will be considered.
10% thresholds = ₹ 6,000 x 10% = ₹ 60

Asset Test:

Combined total assets of all the segment = ₹ 1,02,750
10% thresholds = ₹ 1,02,750 x 10% = 10,275

Accordingly, quantitative thresholds are calculated below:

Segment	L	M	N	O	P	Q	Reportable Segments
% segment sales to total sales	36.66%	24.59%	9.84%	11.48%	13.11%	4.92%	L,M,O,P

% segment profit to total profits	50%	25%	25%	12.5%	15%	10%	L,M,N,O,P,Q
% segment assets to total assets	36.50%	22.63%	15.33%	10.22%	10.22%	5.11%	L,M,N,O,P

Conclusion:

Segments L, M, O and P clearly satisfy the revenue and assets tests and they are separate reportable segments. Segment N does not satisfy the revenue test, but it does satisfy the asset test and it is a reportable segment. Segment Q does not satisfy the revenue or the assets test but is does satisfy the profits test. Therefore, Segment Q is also a reportable segment.

Hence all segments i.e. L, M, N, O, P and Q are reportable segments.

Question 4 *(Inter May 2018) (5 Marks)/(ICAI Study Material)* *Pg no._____*

M/s Nathan Limited has three segments namely P, Q and R. The assets of the company are ₹ 15 crores. Segment P has 4 crores, Segment Q has 6 crores and Segment R has 5 crores. Deferred tax assets included in the assets of each segment are P - ₹ 1 crore, Q - ₹ 0.90 crores and R - ₹ 0.80 crores. The accountant contends all these three segments are reportable segments. Comment.

Solution

According to AS 17 “Segment Reporting”, segment Assets do not include income tax assets. Therefore, the revised total assets are 12.3 crores [₹ 15 – (₹ 1 + 0.9 + 0.8).

Details of Segment wise assets

Segment P holds total assets of ₹ 3 crores (₹ 4 crores – ₹ 1 crores);
Segment Q holds ₹ 5.1 crores (₹ 6 crores – 0.9 crores);
Segment R holds ₹ 4.2 crores (₹ 5 crores – ₹ 0.8 crores).

Thus, all the three segments hold more than 10% of the total assets, all segments are reportable segments. Hence, the contention of the Accountant that all three segments are reportable segments is correct.

Question 5 *(ICAI Study Material)* *Pg no._____*

Microtech Ltd. produces batteries for scooters, cars, trucks, and specialised batteries for invertors and UPS. How many segments should it have and why?

Solution

In case of Microtech Ltd., the basic product is the batteries, but the risks and returns of the batteries for automobiles (scooters, cars and trucks) and batteries for invertors and UPS are affected by different set of factors. In case of automobile batteries, the risks and returns are affected by the Government policy, road conditions, quality of automobiles, etc. whereas in case of batteries for invertors and UPS, the risks and returns are affected by power condition, standard of living, etc. Therefore, it can be said that Microtech Ltd. has two business segments viz- ‘Automobile batteries’ and ‘batteries for Invertors and UPS’

Question 6 *(RTP May 2018/Nov 2019/Nov 2020/May 2021/May/Nov 2022 (Sim.)/ICAI Study Material)* *Pg no.*_____

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?

Solution

AS 17 'Segment Reporting' requires that 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.
Hence, the enterprise can have its own policy for pricing intersegment 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. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Question 7 *(RTP Nov 2018) / (ICAI Study Material)* *Pg no.*_____

Calculate segment results of a manufacturing organization from the following information:

Segments	A	B	C	Total
Directly attributed revenue	5,00,000	3,00,000	1,00,000	9,00,000
Enterprise revenue (allocated in 5 : 4 : 2 basis)				1,10,000
Revenue from transactions with other segments				
Transaction from B	1,00,000		50,000	1,50,000
Transaction from C	10,000	50,000		60,000
Transaction from A		25,000	1,00,000	1,25,000
Operating expenses	3,00,000	1,50,000	75,000	5,25,000
Enterprise expenses (allocated in 5 : 4 : 2 basis)				77,000
Expenses on transactions with other segments				
Transaction from B	75,000		30,000	1,05,000
Transaction from C	6,000	40,000		46,000
Transaction from A		18,000	82,000	1,00,000

Question 8 *(RTP May 2019) / (ICAI Study Material)* *Pg no.*_____

PK Ltd. has identified business segment as its primary reporting format. It has identified India, USA and UK as three geographical segments. It sells its products in the Indian market, which constitutes 70 percent of the Company's sales. 25 per cent is sold in USA and the balance is sold in UK. Is PK Ltd. as part of its geographical secondary segment information, required to disclose segment revenue from export sales, where such sales are not significant?

Solution

As per AS 17 if primary format of an enterprise for reporting segment information is business segments, it should also report segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue.

Accordingly, for the purposes of disclosing secondary segment information, PK Ltd is not required to disclose segment revenue from export sales to UK, since that segment does not meet the 10 per cent or more of enterprise revenue threshold. However, other secondary segment information as per AS 17 should be disclosed in respect of this segment if the thresholds prescribed in the AS 17 are met.

AS 18 : Related Party Disclosures

Related Party

One party has ability to control or exercise significant influence over other party at any time during period

- **Control**
  - Voting Power > 50%
  - Power to compose BOD
  - Power to Direct + Substantial Interest (VP ≥ 20%)
- **Significant Influence**
  - Power to participate in financial &/or operating policy decisions
    - Statute/Law
    - Agreement
    - VP ≥ 20% unless otherwise assumed

Related Party Relationship

3(a): Enterprises directly or indirectly through subsidiary, control or are controlled by or are under common control with entity.

3(b): Associates & Joint venture of Reporting Entity and Investing party or venturer for which Reporting Entity is Associate/J.V.

3(c): Individuals who have control or significant Influence and their relatives*

3(d): Key Management Personnel (KMP) & their relatives*

3(e): Entities where individuals in Para 3(c)/3(d) have significant Influence.

★ Relative: Spouse, Children, Parents, Siblings.

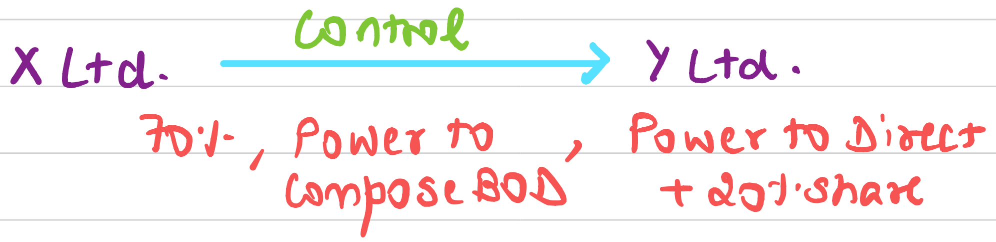
No Related Parties :

1) Two companies simply because of common director
2) Single customer, supplier, Franchiser, Distributor, etc
3) Providers of Finance, Trade unions, Govt. Depts & agencies, etc.

Examples:

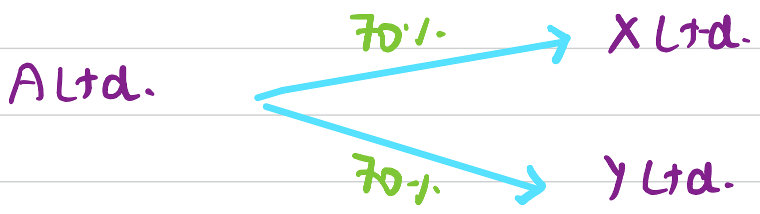
Para 3(a)

1)



X Ltd. & Y Ltd. are RP.

2)



For A Ltd : X Ltd. & Y Ltd. are RP

X Ltd. & Y Ltd. are also RP (Common control)

3)

For X Ltd : Both Y Ltd. & Z Ltd. are RP (Subsidiaries)

4)

For X Ltd: Y Ltd is RP (Subsidiary)

Z Ltd. is RP (Indirectly through subsidiary)

Para 3(b)

1)

X Ltd. & Y Ltd. are RP (Associate)

X Ltd. & Z Ltd. are RP (Joint venture)

2) X Ltd. $\xrightarrow{20\%}$ Y Ltd. $\xrightarrow{20\%}$ Z Ltd.

X Ltd. & Z Ltd. are not RP

3) X Ltd. $\xrightarrow{70\%}$ Y Ltd. $\xrightarrow{20\%}$ Z Ltd.

X Ltd. & Z Ltd. are RP (Indirectly through subsidiary)

4)
$$\begin{tikzcd}
 & \text{Y Ltd.} \\
\text{X Ltd.} \arrow[ur, "20\%"] \arrow[dr, "30\%"'] & \\
 & \text{Z Ltd.}
\end{tikzcd}$$

Y Ltd. & Z Ltd. are not RP
(Common/Fellow Associates/J.V. not RP)

Para 3(c)

1) Mr. X $\xrightarrow[\text{significant Influence}]{\text{Control or}}$ A Ltd.

X & A Ltd. are RP

2) Mr. X $\xrightarrow{70\%}$ A Ltd. $\xrightarrow{20\%}$ B Ltd.

X & B Ltd. are RP (Indirectly through subsidiary)

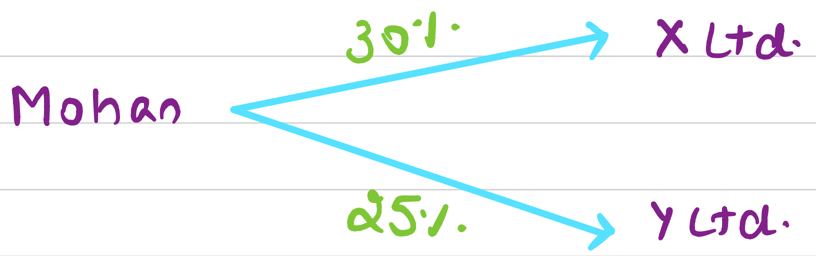
Para 3(d)

1) Mr. X $\xrightarrow{KMP}$ A Ltd.

X & A Ltd. are RP

Para 3(e)

1)

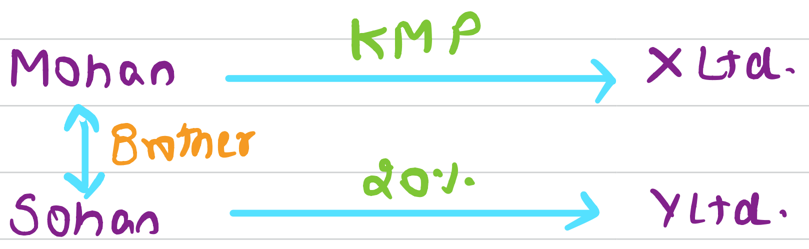


Mohan & X Ltd : RP : 3(c)

Mohan & Y Ltd : RP : 3(c)

X Ltd. & Y Ltd : RP : 3(e)

2)

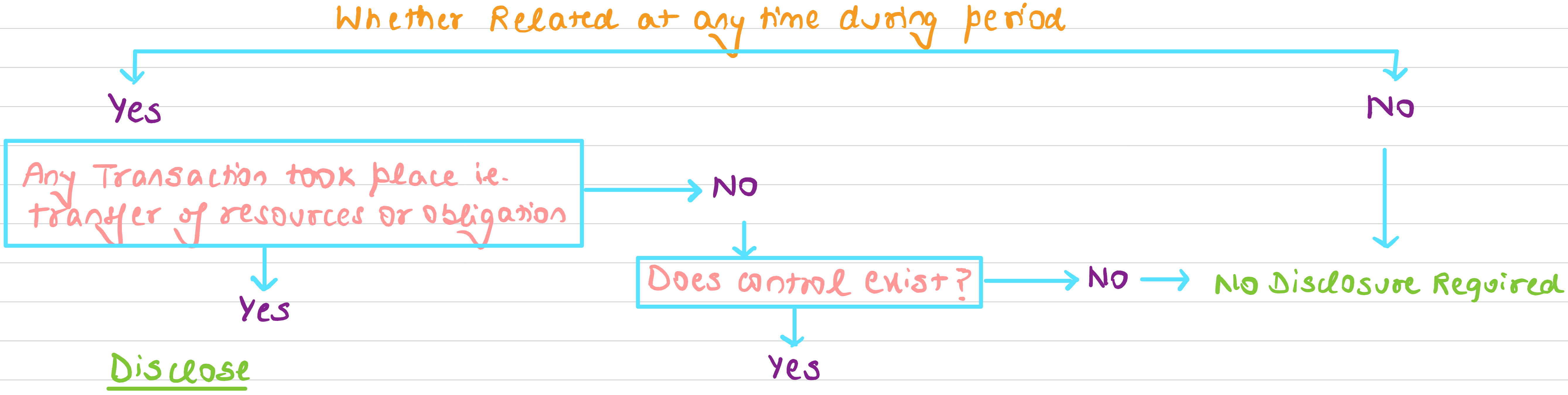


X Ltd : Mohan / Sohan : RP : 3(a)

Y Ltd : Sohan / Mohan : RP : 3(c)

X Ltd. & Y Ltd : RP : 3(e)

Disclosure



a) Name of Related Party
b) Nature of Relationship
c) Nature of Transaction
d) Amount of Transaction
e) Other Elements
f) O/s Balance
g) Amount written off / written back

Disclose

a) Name of Related Party
b) Nature of Relationship

Exceptions of Disclosure Requirements

(1) Transactions during period when no relationship
(2) Disclosures which are against ethics of business ✱
(3) Intragroup transactions in Consolidated financial statements
(4) For Government / State controlled entity
(Transactions of one Govt. entity with other Govt. entity)

✱ Confidentiality as required in terms of statute or regulator or similar competent authority

RELATED PARTY DISCLOSURES

AS 18

Question 1 *(Inter May 2019) (5 Marks) / (ICAI Study Material) / (RTP Nov 2023)*

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

(i) Maya Ltd. holds 61 % shares of Sheetal Ltd.
Sheetal Ltd. holds 51 % shares of Fair Ltd.
Care Ltd. holds 49% shares of Fair Ltd.
(Give your answer - Reporting Entity wise for Maya Ltd., Sheetal Ltd., Care Ltd. & Fair Ltd.)

(ii) Mr. Subhash Kumar is Managing Director of A Ltd. and also holds 72% capital of B Ltd.

Solution

(i)

(a) Reporting entity- Maya Ltd.
- Sheetal Ltd. (subsidiary) is a related party
- Fair Ltd.(subsidiary) is a related party

(b) Reporting entity- Sheetal Ltd.
- Maya Ltd. (holding company) is a related party
- Fair Ltd. (subsidiary) is a related party

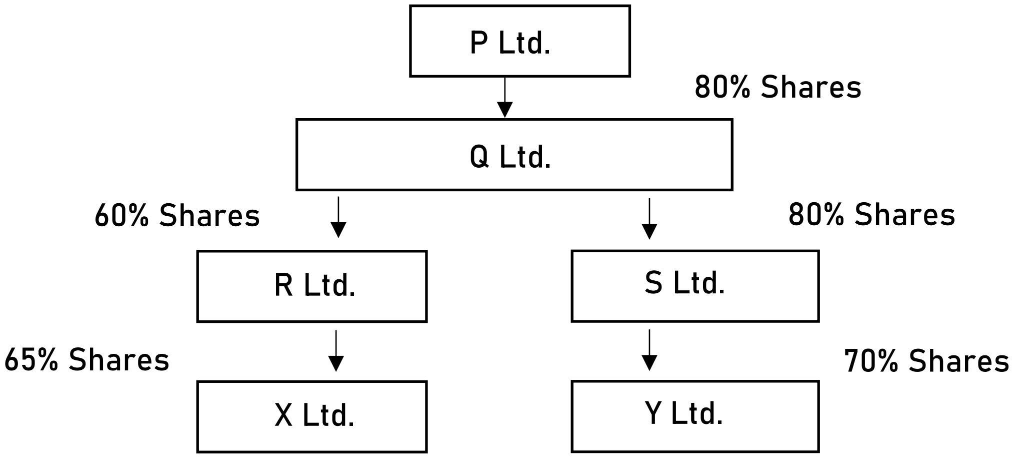
(c) Reporting entity- Fair Ltd.
- Maya Ltd. (holding company) is a related party
- Sheetal Ltd. (holding company) is a related party
- Care Ltd. (investor/ investing party) is a related party

(d) Reporting entity- Care Ltd.
- Fair Ltd. (associate) is a related party

(ii) Mr. Subhash Kumar is Key management personnel as he has the authority for planning, directing and controlling the activities of A Ltd. He also holds substantial interest in B Ltd. as he holds 72% capital of B Ltd. Thus, Mr. Subhash is related party for both A Ltd. and B Ltd. Moreover, as per the definition of related party relationship described in para 3 of AS 18, enterprises over which Subhash is able to exercise significant influence are also related parties. Thus, A Ltd. and B Ltd. will also be construed as related to each other.

Question 2 *(ICAI Study Material)* *Pg no._____*

Consider the following organization structure related to P Ltd.



Given the above structure: Identify related party relationships, if R Ltd. is reporting enterprise

Solution:

The following table identifies related party relationships for R Ltd. (being reporting enterprise)

Party Name	Relationship under AS-18
P Ltd.	• P Ltd. has indirect control on R Ltd. (through Q Ltd.) • Hence R Ltd. is related to P Ltd.
Q Ltd.	• Q Ltd. has direct control of R Ltd. • Hence R Ltd. is related to Q Ltd.
S Ltd.	• R Ltd. and S Ltd. are under common control of Q Ltd. • Hence R Ltd. is related to S Ltd.
X Ltd.	• X Ltd. is controlled by R Ltd. • Hence R Ltd. is related to X Ltd.
Y Ltd.	• Y Ltd. is the sub-subsidiary of Q Ltd. • Both R Ltd. and Y Ltd. are under common control of Q Ltd. • Hence R Ltd. is related to Y Ltd.

Question 3 *(RTP May 2020) / (ICAI Study Material)*

Narmada Ltd. sold goods for ₹ 90 lakhs to Ganga Ltd. during financial year ended 31-3-2020. The Managing Director of Narmada Ltd. own 100% of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices followed by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant, correct?

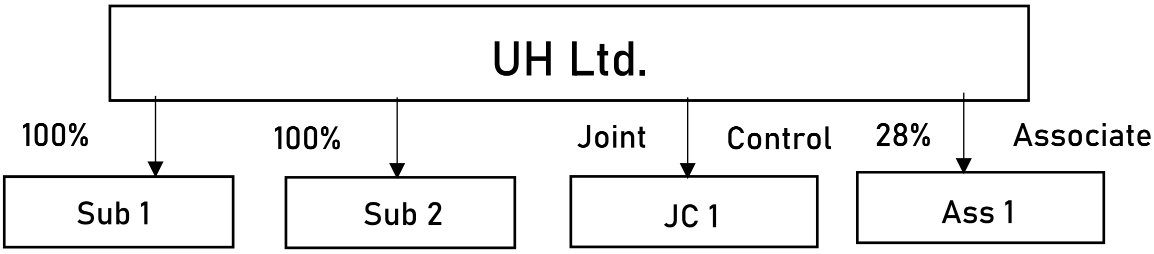
Solution

As per AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise. In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price. Hence the contention of Chief Accountant of Narmada Ltd is wrong.

Question 4 *(ICAI Study Material)* *Pg no.______*

Consider the following organization structure related to UH Ltd. (the ultimate parent company of a Group), wherein UH Ltd. has made the following investments:

- Investment in two of the wholly owned subsidiaries, viz. Sub 1 and Sub 2
- Investment in JC 1, in which UH Ltd. has a joint control
- 28% investment in Ass 1 (and hence, Ass 1 is an associate of UH Ltd.)



Given the above structure: Identify related party relationships for each of the above entities under AS-18

Solution:

The following table identifies related party relationships for each of the entities in the Group:

Reporting enterprise	Related Party as per AS-18
UH Ltd.	All the four entities (viz. Sub 1, Sub 2, JC 1 and Ass 1)
Sub 1	Only two of the entities in the Group (viz. UH Ltd. and Sub 2)
Sub 2	Only two of the entities in the Group (viz. UH Ltd. and Sub 1)
JC 1	Only UH Ltd.
Ass 1	Only UH Ltd.

Question 5 *(ICAI Study Material)* *Pg no.______*

Consider a scenario wherein:

- UK Bank holds 23% equity shares with voting rights in P Ltd.
- The bank has provided a loan of Rs. 20 million to P Ltd. at market interest rate
- As per the terms and conditions of the loan agreement, the bank has appointed one person as its nominee to the board of directors of P Ltd. and any major transaction to be entered into by P Ltd. will require the consent of the Bank.

Determine: Whether under AS-18 - UK Bank is a related party to P Ltd. (the reporting enterprise)?

Solution:

In the instant case, the UK Bank holds 23% shares with voting rights in P Ltd. and hence is deemed to exercise significant influence over P Ltd.

The bank is also a provider of finance to P Ltd. (the reporting enterprise) and as per AS-18, parties like providers of finance are deemed not to be considered as a related party in the course of normal dealings with an enterprise by virtue only of those dealings. However, this exemption will not be available to UK Bank in this case – since it exercises significant influence over P Ltd. (by virtue of holding 23% shares with voting rights in P Ltd.)

Accordingly, for P Ltd. (the reporting enterprise), the UK Bank is a related party and it will be required to disclose the transactions with UK Bank in its financial statements.

Question 6 *(Inter July 2021) (5 Marks)*

(i) Khushi Limited enter into an agreement with Mr. Happy for running a business for a fixed amount payable to the later every year. The contract states that the day-to-day management of the business will be handled by. Mr. Happy, while all financial and operating policy decisions are taken by the Board of Directors of the Company. Mr. Happy does not own any voting power in Khushi Limited.

(ii) Shri Bhanu a relative of key management personnel received remuneration of ₹ 3,50,000 for his services in the company for the period from 1st April, 2020 to 30th June, 2020. On 1st July, 2020, he left the service.

You are required to suggest how the above transactions will be treated as at the closing date i.e. on 31st March, 2021 for the purposes of AS 18- Related Party Disclosures.

Solution

(i) Mr. Happy will not be considered as a related party of Khushi Limited in view of provisions of AS 18 “Related Party Disclosures” which states, "individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual are related parties".

In the given case, in the absence of share ownership, Mr. Happy would not be considered to exercise significant influence on Khushi Limited, even though there is an agreement giving him the power to manage the company. Further, the fact that Mr Happy does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel.

(ii) According to AS 18 on ‘Related Party Disclosures’, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Hence, Shri Bhanu, a relative of key management personnel should be identified as related party for disclosure in the financial statements for the year ended 31.3.2021 as he received remuneration for his services in the company for the period from 1st April,2020 to 30th June,2020.

Question 7 *(Inter May 2023) (5 Marks)*

Pg no.______

Answer the following with respect to AS-18:

a. ABC Ltd. sold goods of ₹ 2,00,000 to its associate company for the 1st quarter ending 30.06.2022. After that the related party relationship ceased to exist. However, goods were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transactions.

b. If the majority of directors of Arjun Ltd. constitute the majority of the Board of another Company Bheem Ltd. in their individual capacity as professionals (and not by virtue of their being Directors in Arjun Ltd.). Are both the companies related?

c. Asha Ltd. sells all the manufactured furniture of ₹1,00,00,000 to Sasha Ltd. as per agreement. Sasha Ltd. is the only customer to Asha Ltd. In the financial statements, Asha Ltd. wants to present Sasha company as a related party. Comment on the disclosure requirement.

Solution

a) As per AS 18, parties are considered to be related if any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party. Transactions of ABC Ltd. with its associate company for the first quarter ending 30.06.2022 only are required to be disclosed as related party transactions as the company has the ability to exercise significant influence only till 30.6.2022.
The transactions for the period in which related party relationship did not exist need not be reported.

b) In the given case, Arjun Ltd. cannot be said to control the composition of board of directors of Bheem Ltd. as the directors have been appointed in their individual capacity as professionals and not by virtue of their being directors in Arjun Ltd.
Hence, it cannot be concluded that the companies are related merely because the majority of the directors of one company became the majority of the directors of the second in their individual capacity as professionals.

c) In the context of AS 18, a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business cannot be construed as Related Party Relationship merely by virtue of the resulting economic dependence. There is an economic dependence between the companies but no one controls or exercise significant influence on the other.
In the given case, Asha Ltd. need not report Sasha Company as its related party in its financial statements.

Question 8 *(ICAI Study Material)*

ABC Limited is in the business of manufacturing textiles. It has certain commercial contracts with its customers and those customer contracts carry various clauses, imposing restriction on ABC Limited for disclosure of certain information. Accordingly, the company doesn’t intend to provide related party disclosure under AS-18 in its ensuing financial statements. Is this correct?

Solution

As per AS-18 stipulate that related party disclosure requirements under AS-18 do not apply in circumstances, where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality, as specifically required in terms of a statute or by any regulator or similar competent authority.

In case, where (1) a statute or (2) a regulator or (3) a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information, which is required to be disclosed as per AS 18, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and AS-18 would not override the obligation to preserve the confidentiality of customers' dealings.

However, this exemption is not available in respect of confidentiality provisions in a commercial contract between two enterprises - where confidentiality is not specifically required in terms of (1) a statute or (2) by any regulator or (3) similar competent authority.

Therefore, in the given case AS-18 related party disclosures would have to be made by ABC Limited in its ensuing financial statements.

AS -19 LEASES

Meaning of Lease	✓ Lease means transfer of right to use assets for specified period against consideration /series of consideration.	
Parties in Lease	*Lessor*	✓ The party who transfers the asset is called 'Lessor'.
	Lessee	✓ The party to whom the asset is transferred is called 'Lessee'.

Types of Lease

Finance Lease

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

Atleast one of the following conditions must be satisfied to recognize the lease as Finance Lease:

→ Transfer of ownership of the asset to the lessee by the end of the lease term.

→ Where lessee has purchase option at very reduced rate & lessee is certain to opt for purchase at inception.

→ Where lease period covers substantial period of economic life of asset.

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

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

Operating Lease

Lease other than finance Lease is Operating Lease.

FINANCE LEASE [Books of Lessee]

Journal Entries:

1) Asset on Lease A/c - Dr

To Lessor A/c

Amount = Lower of

- Present value of Minimum Lease Payments from Stand point of Lessee (MLP_{Lessee})

OR

- Fair Value of Asset

MLP_{Lessee} => Lease Payments / Rentals

\+

Guaranteed Residual value by Lessee or on his behalf

2) Lessor A/c -Dr

Finance charges A/c -Dr

To Bank A/c

3) Depreciation A/c -Dr

To Asset on Lease

4) P&L A/c -Dr

To Finance charges A/c

To Depreciation A/c

Note:

- Rate of Interest would be incremental Rate of Return (IRR)
- Whenever IRR is given, follow given IRR
- If Fair value of Asset < Present value of MLP Lessee, IRR would be recomputed

Example (Question 1)

X Limited has taken machinery on lease from Y Ltd. The information is as under:

Lease Term	4 Years
Fair value at inception of lease	Rs. 16,00,000
Lease Rent	Rs. 5,00,000 p.a. at the end of year
Guaranteed residual value	Rs. 1,20,000
Expected residual value	Rs. 3,50,000
Implicit interest rate	15%

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

a) Calculate the value of the lease liability as per AS-19 & finance charges of each year.

b) Calculate lease liability & finance charges if Fair value is Rs. 14,00,000

Present value of MLP Lessee =

Year	Amount	PVF@15%	Present value
1-4	500000	2.855	1427500
4	120000	0.5718	68616
			1496116

Fair value = 1600000

Lower of above is 1496116

Entry:

Machinery on lease A/c - Dr	1496116	
To Y Ltd. A/c		1496116

Finance Charges

Year	O/s Bal. At Beginning	Interest @ 15%	Instalment	Principal	O/s Bal. At End
A	B	C = BX15%	D	E = D - C	F = B - E
1	1496116	224417	500000	275583	1220533
2	1220533	183080	500000	316920	903613
3	903613	135542	500000	364458	539155
4	539155	80845 (B.f)	620000	539155	-
		623884	2120000		

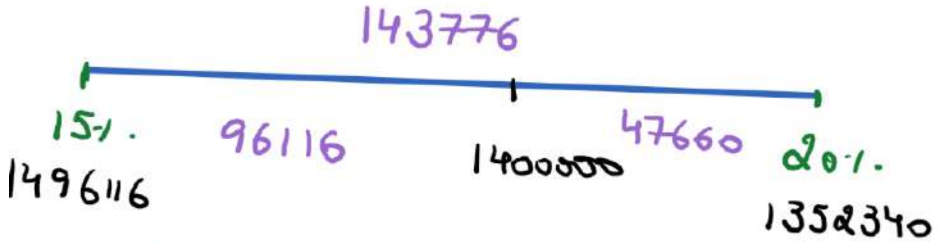
Case (b) P.V. of MLP Lessee = 1496116 Fair value = 1400000

lower is 1400000

Computation of IRR

Let IRR = 20%

Year	Amount	Disc. Factor (20%)	Present value
1-4	500000	2.589	1294500
4	120000	0.482	57840
			1352340



$$15 + \left(\frac{96116}{143776} \times 5\right)$$

18.34%

$$20 - \left(\frac{47660}{143776} \times 5\right)$$

18.34%

Finance Charges

Year	O/s Bal. At Begining	Interest @ 18·34%	Instalment	Principal	O/s Bal. At End
1	1400000	256760	500000	243240	1156760
2	1156760	212150	500000	287850	868910
3	868910	159358	500000	340642	528268
4	528268	91732 (B.f.)	620000	528268	-
		720000	2120000		

FINANCE LEASE [Books of Lessor]

Journal Entries:

1) Lease Receivable / Lessee A/c - Dr
   To Sale / Asset A/c

Amount = Net Investment

Net Investment = Present value of Gross Investment

$$\text{Gross Investment} = \overbrace{\text{Lease Rentals} + \text{Guaranteed Residual value}_{\text{Lessor}}}^{\text{MLP Lessor}} + \text{Unguaranteed Residual value}$$

$$\underbrace{\text{Guaranteed Residual value}_{\text{Lessor}} + \text{Unguaranteed Residual value}}_{\text{Residual value}}$$

GRV_{Lessor} = Higher of

GRV_{Lessee}

or

$GRV_{3rd\ Party}$

2) Bank A/c -Dr

To Lease Receivable / Lessee A/c

To Finance Income A/c

3) Finance Income A/c -Dr

To P&L A/c

Unearned Finance Income = Gross Investment - Net Investment

Question 2 ICAI Study Material

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

Lease Term	5 Years
Fair value of Machine	₹ 48 Lakhs
Lease Rent per annum	₹ 8 Lakhs
Guaranteed residual value	₹ 1.60 Lakhs
Expected residual value	₹ 3 Lakhs
Internal Rate of Return	15%

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

Net Investment

Year	Amount	PVF @ 15%.	Present value
1-5	800000	3.3522	2681760
5	300000 (160000+140000)	0.4972	149160
			2830920

Gross Investment = (8L × 5) + 3L = 4300000

Unearned Finance Income

Gross Inv. − Net Inv.

4300000 − 2830920

⇒ 14,69,080

Question 3 RTP May 2015

X Ltd. has leased equipment over its useful life that costs ₹ 7,46,55,100 for a three year lease period. After the lease term the asset would revert to the Lessor. You are informed that:

(i) The estimated unguaranteed residual value would be ₹ 1 lakh only.

(ii) The annual lease payments have been structured in such a way that the sum of their present values together with that of the residual value of the asset will equal the cost thereof.

(iii) Implicit interest rate is 10%. You are required to ascertain the annual lease payment and the unearned finance income. Annual lease payments are made at the end of each accounting year. P.V. factor @ 10% for years 1 to 3 are 0.909, 0.826 and 0.751 respectively.

Solution

Computation of annual lease payment to the lessor

Cost of equipment	7,46,55,100
Unguaranteed residual value	1,00,000
Present value of residual value after third year @ 10% (₹ 1,00,000 × 0.751)	75,100
Fair value to be recovered from lease payments (₹ 7,46,55,100 – ₹ 75,100)	7,45,80,000
Present value of annuity for three years is 2.486	
Annual lease payment = ₹ 7,45,80,000/ 2.486	**3,00,00,000**

Computation of Unearned Finance Income

Total lease payments (₹ 3,00,00,000 x 3)	9,00,00,000
Add: Unguaranteed residual value	1,00,000
Gross investment in the lease	9,01,00,000
Less: Present value of investment (lease payments and residual value) (₹ 7,45,80,000+ ₹ 75,100)	(7,46,55,100)
Unearned finance income	**1,54,44,900**

Question 4

A machine having expected useful life of 6 years, is leased for 4 years. Both the cost and the fair value of the machinery are ₹ 7,00,000. The amount will be paid in 4 equal instalments and at the termination of lease, lessor will get back the machinery. The unguaranteed residual value at the end of the 4th year is ₹ 70,000. The IRR of the investment is 10%. The present value of annuity factor of ₹ 1 due at the end of 4th year at 10% IRR is 3.169. The present value of ₹ 1 due at the end of 4th year at 10% rate of interest is 0.683. State with reasons whether the lease constitutes finance lease and also compute the unearned finance income

Solution

Determination of nature of lease

Fair value of asset ₹ 7,00,000 Unguaranteed residual value ₹ 70,000

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

Present value of lease payment recoverable = ₹ 7,00,000 - ₹ 47,810 = ₹ 6,52,190

Percentage of present value of lease payment to fair value of asset is = (₹ 6,52,190/₹7,00,000) = 93.17%

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

Calculation of Unearned finance income

Annual lease payment = ₹ 6,52,190 / 3.169 = ₹ 2,05,803 (approx.)

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

= (₹ 2,05,803 x 4) + ₹70000 = ₹ 8,23,212 + ₹70,000 = ₹ 8,93,212

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

= ₹ 8,93,212 – ₹ 7,00,000 (₹ 6,52,190 + ₹ 47,810) = ₹ 1,93,212

Question 5 ICAI Study Material

Classify the following into either operating lease or Finance lease:-

a) Lessee has option to purchase the asset at lower than fair value, at the end of lease term.

b) Economic life of the asset is 7 years, lease term is 6 years, but the asset is not acquired at the end of the lease term.

c) Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for the use of the lessee.

d) Present Value (PV) of Minimum Lease Payment (MLP) = 'X'. Fair value of the asset is 'Y'

Solution

a) If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.

b) The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.

c) Since the asset is procured only for the use of lessee, it is a finance lease.

d) The lease is a finance lease if X = Y, or where X substantially equals Y.

OPERATING LEASE

Lessor ↓ Rental Income

Lessee ↓ Rental Expense

To be recognised in the Statement of P&L in the ratio of benefit derived.

If not available, then SLM is used.

Question 6 ICAI Study Material

A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost ₹ 1,50,000. Economic life of the machine is 5 years and output from the machine are estimated as 40,000 units, 50,000 units, 60,000 units, 80,000 units and 70,000 units consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate. Compute the following:

(i) Annual Lease Rent

(ii)Lease Rent income to be recognized in each operating year and

(iii) Depreciation for 3 years of lease

Solution

(i)Annual lease rent

Total lease rent

$$= 130\% \text{ of ₹ } 1,50,000 \times \frac{\text{Output during lease period}}{\text{Total Output}}$$

= 130% of ₹ 1,50,000 x (40,000 +50,000+ 60,000)/(40,000 + 50,000 + 60,000 + 80,000 + 70,000)

= 1,95,000 x 1,50,000 units/3,00,000 units

= ₹ 97,500

Annual lease rent = ₹ 97,500 / 3 = ₹ 32,500

(ii)**Lease rent Income to be recognized in each operating year**

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 40 : 50 : 60.

Hence income recognised in years 1, 2 and 3 will be as:

Year 1 ₹ 26,000, Year 2 ₹ 32,500 and Year 3 ₹ 39,000.

Deprecation for three years of lease

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 1,50,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 40 : 50 : 60 : 80 : 70 .

Depreciation for year 1 is ₹ 20,000, year 2 = 25,000 and year 3 = 30,000.

SALE & LEASE BACK

Sale & Finance Lease Back:

Any Profit / Loss is to be deferred in the ratio of depreciation over lease period.

Sale & Operating Lease Back:

Step 1: Calculate Impairment Loss: Carrying Amount − Fair value

To be recognised Immediately

Step 2: Calculate Deferred Income: Sale Price − Fair value

To be recognised over Lease period

Step 3: Calculate Difference: +ve or −ve

To be recognised immediately

Exception: If Loss is compensated by future lease payments then it should be amortised over the period.

Example

A Ltd. sold JCB having WDV of Rs. 20 lakhs to B Ltd. for Rs. 24 lakhs and the same JCB was leased back by B Ltd. to A Ltd. The lease is operating lease. In context of AS 19 explain the accounting treatment in the books of A Ltd. if

i. Sale price of Rs. 24 lakhs is equal to fair value.

i. Fair value is Rs. 20 lakhs and sale price is Rs. 24 lakhs.

i. Fair value is Rs. 22 lakhs and sale price is Rs. 25 lakhs.

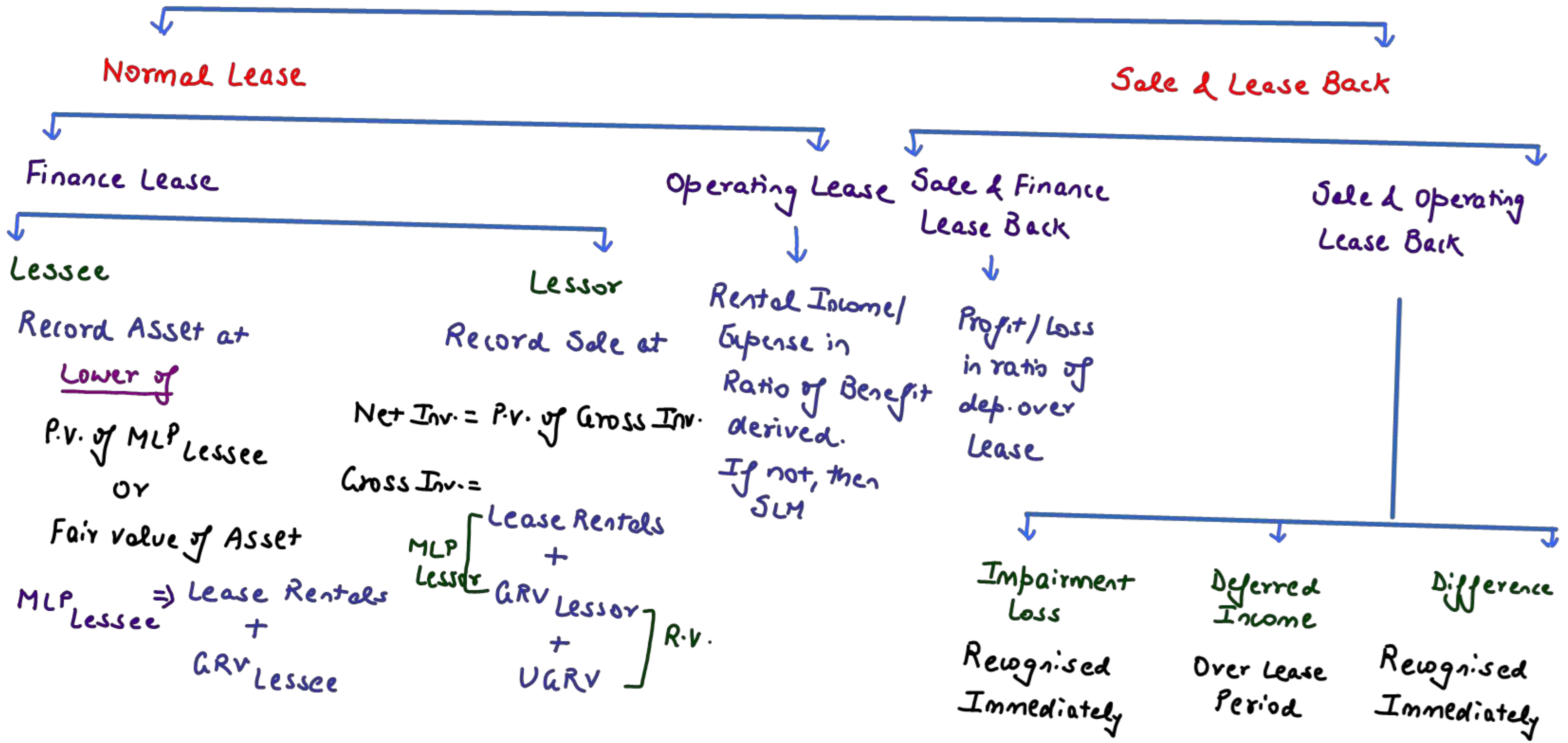
/. Fair value is Rs. 25 lakhs and sale price is Rs. 18 lakhs.

/. Fair value is Rs. 18 lakhs and sale price is Rs. 19 lakhs

	A WDV / Carrying Amt.	B Sale Price	C Fair Value	[A - C] Impairment Loss [WDV - FV = +ve]	[B - C] Deferred Income [SP - FV = +ve]	Difference
a)	20	24	24	-	-	4 Profit
b)	20	24	20	-	4	-
c)	20	25	22	-	3	2 Profit
d)	20	18	25	-	-	2 Loss
e)	20	19	18	2	1	-
				To be Recognised Immediately	To be Recognised over Lease Period	To be Recognised Immediately Subject to exception

Lease Accounting (AS-19)

(Transfer of Right to use asset for specified period against consideration)



Normal Lease

Finance Lease

Lessee

Record Asset at
<u>Lower of</u>
P.V. of MLP_{Lessee}
or
Fair value of Asset

$MLP_{Lessee} \Rightarrow$ Lease Rentals + GRV_{Lessee}

Lessor

Record Sale at

Net Inv. = P.V. of Gross Inv.

Gross Inv. =

$$\underbrace{\left.\begin{array}{l} \text{Lease Rentals} \\ + \\ GRV_{Lessor} \end{array}\right\}}_{MLP_{Lessor}} \qquad \left.\begin{array}{l} GRV_{Lessor} \\ + \\ UGRV \end{array}\right] R.V.$$

Operating Lease

Rental Income/Expense in Ratio of Benefit derived.
If not, then SLM

Sale & Lease Back

Sale & Finance Lease Back

Profit/Loss in ratio of dep. over Lease

Sale & Operating Lease Back

- Impairment Loss: Recognised Immediately
- Deferred Income: Over Lease Period
- Difference: Recognised Immediately

AS-22: ACCOUNTING FOR TAXES ON INCOME

This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period.

Example:

X Ltd.

	Y1	Y2
Income	200000	200000
Expenses [Incl. Bonus of 20000]	(100000)	(100000)
Profit before tax	100000	100000
− Tax	(36000)	(24000)
Profit after tax	64000	76000

Income tax

	Y1	Y2
Income	200000	200000
− Expense	(80000)	(120000)
	120000	80000
Tax 30%	36000	24000

Bonus not allowed in Y1 as per Sec 43B. Allowed in Y2 (For both years)

Accounting for Taxes on Income (AS-22)

(This AS allocates tax expense on systematic basis to each year)

Definitions :

Accounting Income :	Net Profit/(loss) as per Statement of P&L
Taxable Income :	Income / loss as per Tax Laws
Tax Expense :	Current Tax ± Deferred Tax
Current Tax :	Tax calculated as per tax laws
Deferred Tax :	Tax effect on Timing Differences
Timing Differences :	Differences b/w Taxable Income & Accounting Income that originate in one period & capable of reversal in subsequent period
Permanent Differences :	Other than Timing Differences

Accounting Income ≠ Taxable Income

Tax on Accounting Income ≠ Tax on Taxable Income

Tax Expense ≠ Current Tax

Tax Expense = Current Tax ± Deferred Tax

(Debited in P&L A/c) (As per Tax Laws) (Tax Effect on timing Differences)

[+DTL/-DTA]

* Permanent Differences do not result in DTA/DTL

Ⅰ A/cing Income > Taxable Income

DTL = Timing Diff. x Tax Rate

Ⅱ A/cing Income < Taxable Income

DTA = Timing Diff. x Tax Rate

Differences b/w Accounting Income & Taxable Income

Timing Differences

E.g.

- Depreciation Diff.
- Sec 43B: Allowance On Payment Basis
- Deferred Revenue Exp.

↓

DTA/DTL to be Created/recognised

Permanent Differences

E.g.

- Donation
- 40A(3)
- Exempted Income

↓

No Recognition of DTA/DTL

Example: Y_1 to Y_4 Profit Before Dep. & tax 500000

Tax Rate: 30%

Dep. as per books 100000 p.a.

Dep. as per Income tax:

150000, 110000, 80000, 60000

Statement of P&L

	Y_1	Y_2	Y_3	Y_4
Profit	500000	500000	500000	500000
– Depreciation	(100000)	(100000)	(100000)	(100000)
Profit Before tax	400000	400000	400000	400000
– Tax Expense				
Current tax	(105000)	(117000)	(126000)	(132000)
Deferred tax	(15000)	(3000)	6000	12000
Profit after tax	280000	280000	280000	280000

Current tax

	Y_1	Y_2	Y_3	Y_4
Profit	500000	500000	500000	500000
− Depreciation	(150000)	(110000)	(80000)	(60000)
	350000	390000	420000	440000
Tax @ 30%	105000	117000	126000	132000

Deferred tax

	Y_1	Y_2	Y_3	Y_4
Opening	-	50000	60000	40000
Created	50000	10000	—	—
Reversed	—	—	(20000)	(40000)
Closing	50000	60000	40000	Nil
Tax 30% Deferred tax	15000	18000	12000	—

P&L 15000 To DTL 15000	P&L 3000 To DTL 3000	DTL 6000 To P&L 6000	DTL 12000 To P&L 12000

Timing Differences

- Accounting Income > Taxable Income
  - Fresh Difference
    - DTL = Timing Diff. X Tax Rate
  - Earlier Difference
    - DTA earlier made to be reversed
- Accounting Income < Taxable Income
  - Fresh Difference
    - DTA = Timing Diff. X Tax Rate
  - Earlier Difference
    - DTL earlier made to be reversed

DTA: Should be created subject to prudence limits.

Entities having unabsorbed Dep./ carry forward of losses:
Create DTA if there is VCCE (Virtual certainity with convincing evidence) that there will be future taxable income against which DTA can be adjusted.

Other Entities: Create DTA if there is reasonable certainity.

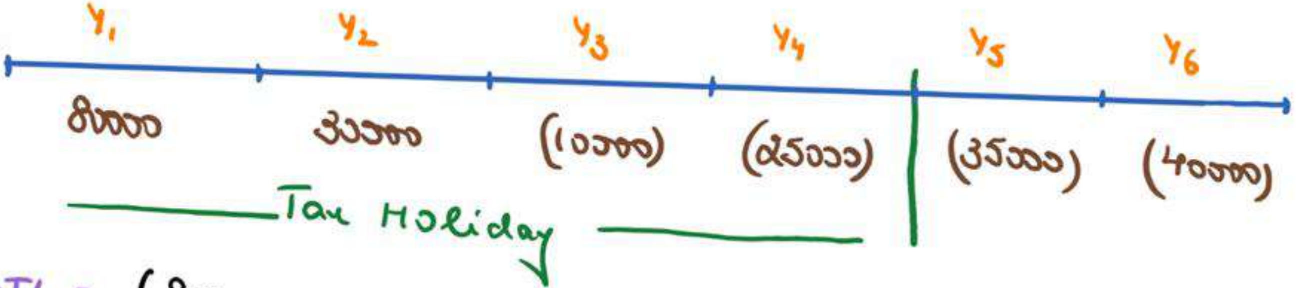
Note: DTA/DTL should not be discounted to their present value.

Tax Holiday:

- ★ Timing Differences will be taken on FIFO Basis.
- ★ Timing Differences which arise in tax holiday & are capable of reversal in tax holiday will be ignored.

Example: Tax holiday period Y_1 to Y_4 Tax Rate 30%.

	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6
Dep. as per books	100000	100000	100000	100000	100000	100000
Dep. as per tax laws	180000	130000	90000	75000	65000	60000



Y_1 DTL = $(80000 - 10000 - 25000) \times 30\% = 13500$

Y_2 DTL = $30000 \times 30\% = 9000$

Y_3 Nil

Y_4 Nil

Y_5 Reversal of DTL = $35000 \times 30\% = 10500$

Y_6 Reversal of DTL = $40000 \times 30\% = 12000$

Minimum Alternate Tax (MAT)

Sec 115JB of Income Tax Act, 1961

Tax Payable for the year

Higher of

$$\begin{bmatrix}\text{Taxable Income} \\ \times \\ \text{Tax Rate}\end{bmatrix} \text{ OR } \begin{bmatrix}\text{Book Profit} \\ \times \\ \text{MAT Rate}\end{bmatrix}$$

MAT Credit = Excess of MAT paid over Tax on Total Income. It is an asset

Case 1:

Taxable Income = 1000000

Tax Rate = 30%

Book Profit = 2500000

MAT Rate = 15%

Case 2:

Taxable Income = 1000000

Tax Rate = 30%

Book Profit = 1200000

MAT Rate = 15%

Deferred Tax : Tax Effect of Timing Differences between Accounting Income & Taxable Income to be calculated using regular tax rates & not MAT rate.

Tax Expense = Current Tax ± Deferred Tax

⇓

Tax Liability as per provisions of Income Tax & not Tax Payable as per Sec 115JB

* DTA/DTL not recognised on basis of Sec 115JB.

ACCOUNTING FOR TAXES ON INCOME

AS 22

Question 1 *(ICAI Study Material)*

Pg no._____

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 2017-2018, 2018-2019 and 2019-2020 for ₹ 11,00,000, ₹ 16,00,000 and ₹ 21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognised revenue of ₹ 7,00,000, ₹ 18,00,000, and ₹ 23,00,000 for years 2017-2018, 2018-2019 and 2019-2020 respectively. Income-tax rate 35%. Compute the amount of deferred tax asset/ liability for the years 2017-2018, 2018-2019 and 2019-2020.

Solution

Table showing calculation of deferred tax asset / liability

Year	Accounting Income	Taxable Income	Timing Difference	Deferred Tax @35%	Deferred Tax
2017-18	11,00,000	7,00,000	4,00,000	1,40,000	Deferred Tax Liability
2018-19	16,00,000	18,00,000	(2,00,000)	(70,000)	Reversal of DTL
2019-20	21,00,000	23,00,000	(2,00,000)	(70,000)	Reversal of DTL
	48,00,000	48,00,000			

Question 2 *(Inter May 2018) (5 Marks)*

Pg no._____

Rohit Ltd. has provided the following information:

Particulars	Amount
Depreciation as per accounting records	2,50,000
Depreciation as per tax records	5,50,000
Unamortised preliminary expenses as per tax record	40,000

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

Solution

Table showing calculation of deferred tax asset / liability

Particulars	Amount	Timing Difference	Deferred Tax	Amount @ 50%
Excess depreciation as per tax records (5,50,000 – 2,50,000)	3,00,000	Timing	Deferred Tax Liability	1,50,000
Unamortised preliminary expenses as per tax records	40,000	Timing	Deferred Tax Asset	20,000
Net deferred tax liability				1,30,000

Net deferred tax liability amounting ₹ 1,30,000 should be recognized as transition adjustment.

Question 3 *(RTP May 2022)*

Pg no._____

The following transactions were reported by PQR Ltd. during the year 2020-2021:

(i)	Tax Rate	30%
		(₹ In Lakhs)
(ii)	Items disallowed in 2019-20 & allowed for tax purposes in 2020-21	20.00
(iii)	Interest to Financial Institutions accounted in the books on accrual basis, but actual payment was made before the due date of filing return and allowed for tax purpose also.	20.00
(iv)	Donations to Private Trust made in 2020-2021 (not allowed under Income Tax Laws)	10.00

You are required to show impact of the above items in terms of Deferred Tax Assets/Deferred Tax Liability for the year ended 31.03.2021.

Solution

Impact of various items in terms of deferred tax liability/deferred tax asset on 31.3.21

Transactions	Analysis	Nature of difference	Effect	Amount (₹)
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Timing difference	Reversal of DTA	20 lakhs x 30% = ₹ 6 lakhs
Interest to financial institutions	It is allowed as deduction under IT Act, if the payment is made before the due date of filing the return of income	No Timing difference	Not Applicable	Not Applicable
Donation to private trusts	Not an allowable expenditure under IT Act.	Permanent difference	Not Applicable	Not Applicable

Question 4 *(Inter July 2021) (5 Marks)* *Pg no._____*

Following particulars are stated in the Balance Sheet of Deep Limited as on 31st March, 2020:

	(₹ In Lakhs)
Deferred Tax Liability (Cr.)	28.00
Deferred Tax Assets (Dr.)	14.00

The following transactions were reported during the year 2020 -2021:

(i) Depreciation as per books was ₹ 70 Lakhs whereas Depreciation for Tax purposes was ₹ 42 Lakhs. There were no additions to Fixed Assets during the year.

(ii) Expenses disallowed in 2019-20 and allowed for tax purposes in 2020-21 were ₹ 14 Lakhs.

(iii) Share issue expenses allowed under section 35(D) of the Income Tax Act, 1961 for the year 2020-21 (1/10th of ₹ 70.00 lakhs incurred in 2019-20).

(iv) Repairs to Plant and Machinery were made during the year for ₹ 140.00 Lakhs and was spread over the period 2020-21 and 2021-22 equally in the books. However, the entire expenditure was allowed for income-tax purposes in the year 2020-21.

Tax Rate to be taken at 40%.

You are required to show the impact of above items on Deferred Tax Assets and Deferred Tax Liability as on 31st March, 2021.

Solution

Impact of various items in terms of deferred tax liability/deferred tax asset on 31.3.21

Transactions	Analysis	Nature of difference	Effect	Amount (₹)
Difference in depreciation	Generally, WDV method of dep. is adopted under IT Act which leads to higher dep. in earlier years of useful life of asset in comparison to later years.	Responding timing difference	Reversal of DTL	28 lakhs x 40% = ₹ 11.20 lakhs
Disallowances, as per IT Act, of earlier years	Tax payable for the earlier year was higher on this account.	Responding timing difference	Reversal of DTA	14 lakhs x 40% = 5.6 lakhs
Share issue expenses	Due to disallowance of full expenditure under IT Act, tax payable in the earlier years was higher.	Responding timing difference	Reversal of DTA	7 lakhs x 40% = ₹ 2.8 lakhs
Repairs to plant and machinery	Due to allowance of full expenditure under IT Act, tax payable of the current year will be less.	Originating timing difference	Increase in DTL	70 lakhs x 40% =28 lakhs

Question 5 *(Inter Nov 2022) (5 Marks)* *Pg no.*_____

The following information is furnished in respect of Mohit Limited for the year ending 31st March,2022.

a) Depreciation as per accounting records ₹ 56,000
Depreciation for income tax records ₹ 38,000.
The above depreciation does not include depreciation on new addition.

b) A new machinery purchased on 1st April, 2021 costing ₹ 24,000 on which 100% depreciation in allowed in the 1st Year for income tax purpose, whereas straight line method of depreciation is considered appropriate for accounting purpose with a life estimation of 4 years.

c) The company has made a profit of ₹ 1,28,000 before depreciation and taxes.

d) Donation to private trust during the year is ₹ 15,000 (not allowed under Income tax laws.)

e) Corporate tax is 40%.

Prepare relevant extract of statement of Profit & Loss for the year ending 31st March, 2022. Also show the effect of the above items on Deferred Tax Liability/Assets as per AS 22.

Solution:

Statement of profit and Loss for the year ended 31st March, 2022 (An Extract)

	₹
Profit before taxes and depreciation	1,28,000
Less: Depreciation (56,000+ 6,000)	(62,000)
Profit before tax	66,000
Less: Current tax (W.N)	(32,400)
Deferred Tax	Nil
Profit after tax	33,600

Working Note:

Computation of taxable income

	₹
Profit before taxes and depreciation	1,28,000
Less: Depreciation (38,000+ 24,000)	(62,000)
	66,000
Add: Donation*	15,000
	81,000
Current tax (40%)	32,400

Note: The profit of ₹ 1,28,000 given in question is before depreciation and taxes. It has been considered that this amount is after making adjustment of donation amounting ₹ 15,000.

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

	Transactions	Nature of difference	Effect	Amount
1.	Difference in depreciation (old machinery)	Timing difference	Reversal of DTL	₹ 18,000 (56,000 – 38,000) *40% = (+) ₹ 7,200
2.	Depreciation on new machinery	Timing difference	Creation of DTL	₹ 18,000 (24,000 – 6,000) *40%= (-) ₹ 7,200
3.	Donation to private trusts	Permanent difference	Not applicable	--
	Net Effect of Deferred Tax			Nil

Question 6 Pg no._____

A company, ABC Ltd., prepares its accounts annually on 31st March. The company has incurred a loss of ₹ 1,00,000 in the year 2018 and made profits of ₹ 50,000 and 60,000 in year 2019 and year 2020 respectively. Under the tax laws, loss can be carried forward for 8 years and tax rate is 40% and at the end of year 2018, it was virtually certain, supported by convincing evidence, that the company would have sufficient taxable income in the future years against which unabsorbed depreciation and carry forward of losses can be set-off. Also there is no difference between taxable income and accounting income except that set-off of loss is allowed in years 2019 and 2020 for tax purposes. Current tax in the year 2020 is ₹ 4,000. Show the effect of above transactions by preparing the Statement of Profit and Loss

Solution

Statement of Profit & Loss

	2018	2019	2020
Profit / (Loss)	(1,00,000)	50,000	60,000
Less: Current Tax	-	-	(4,000) [10,000*40%]
Deferred Tax: Tax effect of timing differences originating during the year (1,00,000 x 40%) Tax effect of timing differences reversed/ adjusted during the year (50,000 x 40%)	40,000	(20,000)	(20,000)
Profit / (Loss) after tax	(60,000)	30,000	36,000

Question 7 – *(ICAI Study Material)* Pg no._____

Y Ltd. is a full tax free enterprise 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 ₹ 200 lakhs and ₹ 400 lakhs respectively. From the third year it is expected that the timing difference would reverse each year by ₹ 10 lakhs. Assuming tax rate of 40%, find out the deferred tax liability at the end of the second year and any charge to the Profit & Loss account.

Solution

As per AS 22, 'Accounting for Taxes on Income', deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised.

Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of ₹ 200 lakhs timing difference due to depreciation, difference amounting ₹ 80 lakhs (₹ 10 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognised. However, for ₹ 120 lakhs (₹ 200 lakhs – ₹ 80 lakhs), deferred tax liability will be recognised for ₹ 48 lakhs (40% of ₹ 120 lakhs) in first year.

In the 2nd year, entire amount of timing difference of ₹ 400 lakhs will reverse only after tax holiday period & hence, will be recognised in full. Deferred tax liability amounting ₹ 160 lakhs (40% of ₹ 400 lakhs) will be created by charging it to profit & loss account and total balance of deferred tax liability account at end of 2nd year will be ₹ 208 lakhs (48 lakhs + 160 lakhs).

Question 8 *(Inter Nov 2020) (5 Marks) / (RTP Nov 2023)* *Pg no.*_____

From the following details of Aditya Limited for accounting year ended on 31st March, 2020

Particulars	₹
Accounting Profit	15,00,000
Book Profit as per MAT	7,50,000
Profit as per Income Tax Act	2,50,000
Tax Rate	20%
MAT Rate	7.50%

You are required to calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Solution

Tax as per accounting profit 15,00,000 x 20% = ₹ 3,00,000
Tax as per Income-tax Profit 2,50,000 x 20% = ₹ 50,000
Tax as per MAT 7,50,000 x 7.50% = ₹ 56,250

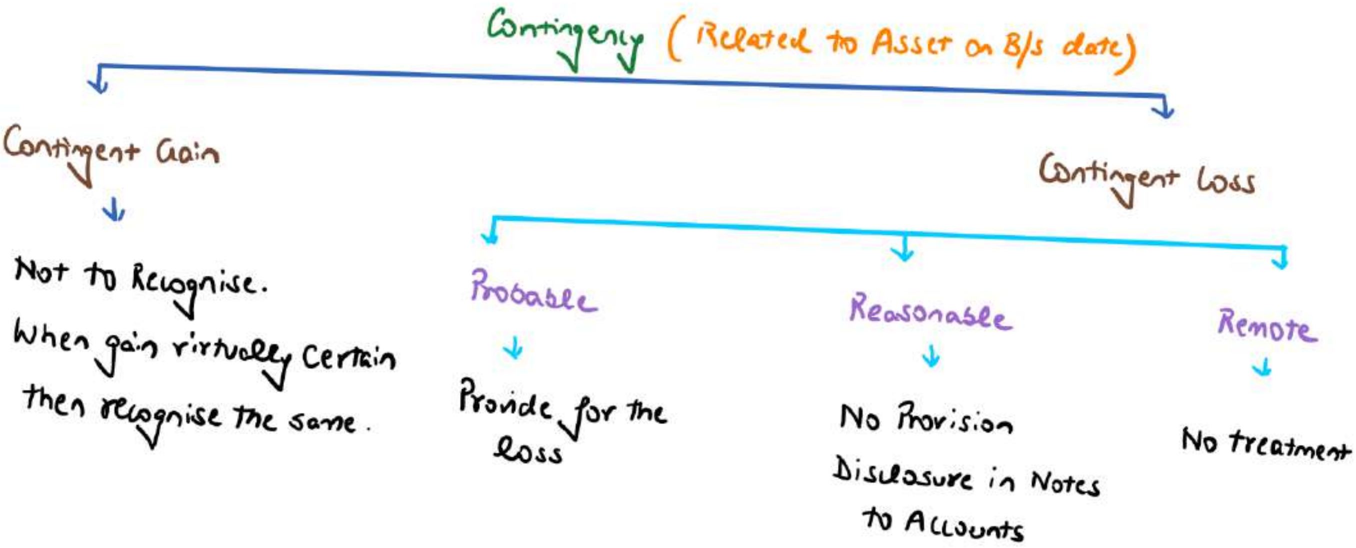
Tax expense= Current Tax + Deferred Tax
₹ 3,00,000 = ₹ 50,000+ Deferred tax
Therefore, Deferred Tax liability as on 31-03-2020 = ₹ 3,00,000 – ₹ 50,000 = ₹ 2,50,000

Amount of tax to be debited in Profit and Loss account for the year 31-03-2020
Current Tax + Deferred Tax liability + Excess of MAT over current tax
= ₹ 50,000 + ₹ 2,50,000 + ₹ 6,250 (56,250 – 50,000) = ₹ 3,06,250

CONTINGENCIES AND EVENTS OCCURRING AFTER BALANCE SHEET DATE

Contingencies :

Condition or situation, outcome of which gain or loss will be determined on the occurrence or non occurrence of uncertain future event.



EVENTS OCCURRING AFTER BALANCE SHEET DATE	
Meaning	These are 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 company, and the corresponding approving authority, in case of any other entity.

TYPES OF EVENTS (PARA 8)

Adjusting events	Non-Adjusting events
↓	↓
Those which provide further/additional evidence to assist estimation of amounts relating to conditions that existed at the balance sheet date	Those which are indicative of conditions that arose subsequent to balance sheet date or events which do not relate to conditions existing at balance sheet date

Require adjustments to assets and liabilities as at balance sheet date	No accounting treatment: No adjustment of assets & liabilities (Refer note)
Example: an adjustment may be made for loss on trade receivable account which is confirmed by insolvency of customer which occurs after the b/sheet date	Example: Ordinary decline in market value of investments between the balance sheet date and date on which financial statements are approved does not require any adjustment.

Note: Non adjusting events may be of such significance that they may require a disclosure in the report of approving authority i.e. report of BOD to enable users of financial statements to make proper evaluations and decisions.

Example: Material changes and commitments affecting the financial position of enterprise.

EXCEPTION TO THE RULE OF "NO ACCOUNTING TREATMENT FOR NON ADJUSTING EVENTS"

Fundamental accounting assumption of GOING CONCERN is not appropriate
Deterioration in operating results and financial position
Unusual changes affecting the existing or sub-stratum of the enterprise after the balance sheet date (eg. Destruction of major production plant by fire after the balance date)
Assets and liabilities should be adjusted i.e. financial statements should be prepared by not following fundamental accounting assumption of GOING CONCERN *In case the going concern assumption is not valid (based on events occurring after the balance sheet date), the financial statements are prepared on a liquidation basis.*

SPECIAL CASE: PROPOSED DIVIDEND

There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature.

For example, if dividends are declared after the balance sheet date but before the financial statements are approved for issue, the dividends are not recognized as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. No liability for proposed dividends must be created now. Such proposed dividends are to be disclosed in the notes.

DISCLOSURE REQUIREMENTS

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

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

Case (1)

MEC Limited could not recover an amount of ₹ 8 lakhs from a debtor. The company is aware that the debtor is in great financial difficulty. The accounts of the company for the year ended 31-3-2023 were finalized by making a provision @ 25% of the amount due from that debtor. In May 2023, the debtor became bankrupt and nothing is recoverable from him.
Do you advise the company to provide for the entire loss of ₹ 8 lakhs in books of account for the year ended 31-3-2023?

Solution

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 2023 is only an additional information to the condition existing on the balance sheet date.
Therefore, the company is advised to provide for the entire amount of ₹ 8 lakhs in the books of account for the year ended 31st March, 2023.

Case (2)

In Raj Co. Ltd., theft of cash of ₹ 2 lakhs by the cashier in January, 2023 was detected in May, 2023. 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 31.3.2023. Decide.

Solution

Though the theft, by the cashier ₹ 2,00,000, was detected after the balance sheet date (before approval of financial statements) but it is an additional information materially affecting the determination of the cash amount relating to conditions existing at the balance sheet date.

Therefore, it is necessary to make the necessary adjustments in the financial statements of the company for the year ended 31st March, 2023 for recognition of the loss amounting ₹ 2,00,000.

Case (3)

An agreement to sell a land for ₹ 30 lakh to another company was entered into on 1st March, 2023. The value of land is shown at ₹ 20 lakh in the Balance Sheet. However, the Sale Deed was registered on 15th April, 2023.

Solution

Agreement to sell was effected on 1st March, 2023 i.e. before the balance sheet date. Registration of the sale deed on 15th April, 2023, 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, 2023.

Case (4)

X Ltd. sends a proposal to purchase an immovable property for ₹ 30 lakhs in March. The book value of the property is ₹ 20 lakhs as on year end date. However, the deed was registered as on 15th April.

Solution

In the given case, proposal for deal of immovable property was sent before the closure of the books of accounts. This is a non-adjusting event as only the proposal was sent and no agreement was effected in the month of March i.e. before the balance sheet date.

Case (5)

The negotiation with another company for acquisition of its business was started on 2nd February, 2023. Pradeep Ltd. invested ₹ 40 lakh on 12th April, 2023.

Solution

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, 2023.

Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 40 lakhs in April, 2023 in the acquisition of another company should be disclosed in report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

Case (6)

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 ₹ 40 lakhs.

Solution

As the term and conditions of acquisition of business of another company had been decided by the end of March, acquisition of business is an adjusting event occurring after the balance sheet date. Adjustment to assets and liabilities is required since the event affects the determination and the condition of the amounts stated in the financial statements for the financial year ended on 31st March.

Case (7)

An earthquake destroyed a major warehouse of PQR Ltd. on 30.4.2023. The accounting year of the company ended on 31.3.2023. The accounts were approved on 30.6.2023. The loss from earthquake is estimated at ₹ 25 lakhs.

State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

Solution

Case (a): If going concern assumption is not Valid

Since the fire occurred after 31/03/23, the loss on fire is not a result of any condition existing on 31/03/23. But the loss due to fire is an adjusting event the entire accounts need to be prepared on a liquidation basis with adequate disclosures by the company by way of note in its financial statements in the following manner:

“Major fire occurred in the warehouse on 30th April, 2023 which has made impossible for the enterprise to start operations again. Therefore, the financial statements have been prepared on liquidation basis.”

Case (b): If going concern assumption is still Valid

The fact of earthquake together with an estimated loss of ₹ 25 lakhs should be disclosed in the repot of the approving authority for the financial year 2022-2023.

Case (8)

During the year 2022-2023, Raj Ltd. was sued by a competitor for ₹ 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of ₹ 10 lakhs in its financial statements for the year ended 31st March, 2023. On 18th May, 2023, the Court decided in favour of the party alleging infringement of the trademark and

ordered Raj Ltd. to pay the aggrieved party a sum of ₹ 14 lakhs. The financial statements were prepared by the company's management on 30th April, 2023, and approved by the board on 30th May, 2023.
Should Raj Ltd. adjust its financial statements for the year ended 31st March, 2023?

Solution

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 2022-23 for which the provision was also made by it, the decision of the Court on 18th May, 2023, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Question

Neel Limited has its corporate office in Mumbai and sells its products to stockists all over India. On 31st March, 2020 the company wants to recognize receipt of cheques bearing date 31st March, 2020 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 2020 and are also realized in the same month in normal course after deposit in the bank.

State with reasons, whether each of the following is an adjusting event and how this fact is to be disclosed by the company, with reference to the relevant accounting standard

(i) Cheques collected by the marketing personnel of the company from the stockists on or before 31st March, 2020.

(ii) Cheques sent by the stockists through courier on or before 31st March, 2020.

Solution

(1) Cheques collected by the marketing personnel of the company is an adjusting event as the marketing personnels are employees of the company and therefore, are representatives of the company. Handing over of cheques by the stockist to the marketing employees discharges the liability of the stockist. Therefore, cheques collected by the marketing personnel of the company on or before 31st March, 2020 require adjustment from the stockists' accounts i.e. from 'Trade Receivables A/c' even though these cheques (dated on or before 31st March, 2020) are presented in the bank in the month of April, 2020 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.

(2) Even if the cheques bear the date 31st March or before and are sent by the stockists through courier on or before 31st March, 2020, it is presumed that the cheques will be received after 31st March. Collection of cheques after 31st March, 2020 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 *(Inter July 2021) (5 Marks)*

Surya Limited follows the financial year from April to March. It has provided the following information.

(a) A suit against the Company's Advertisement was filed by a party on 5th April, 2021, claiming damages of ₹ 5 lakhs.

(b) Company sends a proposal to sell an immovable property for ₹ 45 lakhs in March 2021. The book value of the property is ₹ 30 lakhs as on year end date. However, the Deed was registered on 15th April, 2021.

(c) The terms and conditions for acquisition of business of another company have been decided by the end of March 2021, but the financial resources were arranged in April 2021. The amount invested was ₹ 50 lakhs.

(d) Theft of cash amounting to ₹ 4 lakhs was done by the Cashier in the month of March 2021 but was detected on the next day after the Financial Statements have been approved by the Directors.

Keeping in view the provisions of AS-4, state with reasons whether the above events are to be treated as Contingencies, Adjusting Events or Non-Adjusting Events occurring after Balance Sheet date.

Solution

(a) Suit filed against the company is a contingent liability but it was not existing as on date of balance sheet date as the suit was filed on 5th April after the balance sheet date. As per AS 4, 'Contingencies' is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur. However, it may be disclosed with the nature of contingency, being a contingent liability. This event does not pertain to conditions on the balance sheet date. Hence, it will have no effect on financial statement and will be a non-adjusting event.

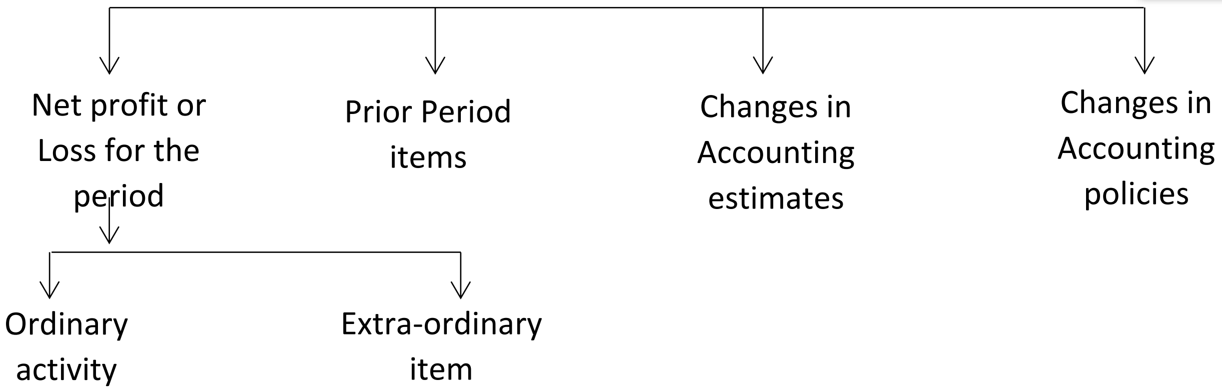
(b) In this case, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2021. There was just a proposal before 31st March, 2021 and hence sale cannot be shown in the financial statements for the year ended 31st March, 2021. Sale of immovable property is an event occurring after the balance sheet date is a non-adjusting event.

(c) In the given case, terms and conditions for acquisition of business were finalized before the balance sheet date and carried out before the closure of the books of accounts but transaction for payment of financial resources was effected in April, 2021.
Hence, it is an adjusting event and necessary adjustment to assets and liabilities for acquisition of business is necessary in the financial statements for the year ended 31st March 2021.

(d) Only those events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.
In the given case, as the theft of cash was detected after approval of financial statements, no adjustment is required. Hence it is non-adjusting event.

NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS & CHANGES IN ACCOUNTING POLICIES

AS 05



NET PROFIT OR LOSS FOR THE PERIOD		
General rule	All items of income & expense which are recognized in a period should be included in the determination of Net Profit or loss for the period including extra-ordinary items, effects of changes in accounting estimates.	
Profit or loss from ordinary activity	Meaning	These are the principle revenue producing and generating activities and incidental items. Any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities. For example: Profit on sale of merchandise, loss on sale of unsold inventory at the end of the season.
	Requirement under AS-5 (PARA 12)	The nature and amount of such items is to be disclosed separately if they are of such size, nature or incidence that their disclosure is relevant to explain the performance of enterprise for the period.
	Example	➢ Writing down of inventories to NRV or vice-versa ➢ Disposal of fixed assets ➢ Disposal of long-term investments ➢ Legislative changes having retrospective effect ➢ Litigation settlements ➢ Restructuring of activities of an enterprise & reversal of provisions for the costs of restructuring.
Extra-ordinary Items	Meaning	These are the activities which are not ordinary. These are irregular & infrequent in nature. Only on rare occasions, an event or transactions gives rise to an extra-ordinary item.
	Requirement under AS-5 (PARA 8)	Should be disclosed in the Statement of P&L as a part of Net Profit or loss for the period.

<table>
<tr><td rowspan="2"></td><td></td><td>Their <u>nature and amount</u> should always be separately disclosed in the statement of P&L in a manner that its <u>impact on current profit or loss can be perceived</u>.</td></tr>
<tr><td>Example</td><td>➢ Loss by earthquake, flood etc.
➢ Attachment of property of the enterprise (confiscation of property by tax officials)
➢ Government grant becoming refundable.</td></tr>
<tr><td colspan="3">PRIOR PERIOD ITEM</td></tr>
<tr><td>Meaning</td><td colspan="2">These are the items of incomes and expenses which arise in the current period as a result of error or omissions in the preparation of financial statements of one or more previous periods.</td></tr>
<tr><td>Reasons</td><td colspan="2">These may occur due to:
✓ Mathematical mistakes
✓ Mistakes in applying accounting policies
✓ Due to over sight</td></tr>
<tr><td>Requirement as per AS-5 (PARA 15)</td><td colspan="2">Their <u>nature and amount</u> is to be separately disclosed in the Statement of P&L in such a manner that their impact on the current profit or loss can be perceived.</td></tr>
<tr><td>Example</td><td colspan="2">➢ Revenue expenditure treated as capital expenditure or vice –versa
➢ Wrong totaling of stock.</td></tr>
<tr><td colspan="3">CHANGE IN ACCOUNTING ESTIMATES</td></tr>
<tr><td>Meaning of Accounting estimate</td><td colspan="2">As a result of uncertainties inherent in business activities, many financial statement items cannot be measured with precisions but can only be estimated.
The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.</td></tr>
<tr><td>Example</td><td colspan="2">➢ Estimate of bad debts
➢ Useful life of depreciable assets
➢ Estimates of inventory obsolescence</td></tr>
<tr><td>When change in accounting estimates occur</td><td colspan="2">✓ As a result of new information
✓ As a result of more experience
✓ As a result of subsequent development
✓ If changes occur regarding the circumstances on which the estimate was based</td></tr>
<tr><td>Notes</td><td colspan="2">✓ It is not a prior period item
✓ The revision of the estimate by its nature does not bring the adjustments within the definitions of an extraordinary item or prior period item.
✓ The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate</td></tr>
</table>

	✓ The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed *(Para 27)*
CHANGE IN ACCOUNTING POLICY	
General rule	Accounting policy once adopted should not be changed i.e. these should be applied consistently.
When is change recommended	A change in accounting policy should be made only if adoption of different accounting policy is required → By Statute i.e. by Law or → For Compliance with an Accounting standard or → If it is considered that change would result in more appropriate presentation of financial statements.
Disclosure requirements	✓ Any change in accounting policy having material effect is to be disclosed. ✓ If the effect of such change is material it should be shown in financial statement of the period in which such change is made. ✓ Where effect of change is not ascertainable, fact should be disclosed. ✓ If the impact of such change is not material in current period but is expected in later periods, then the fact of change is to be disclosed.
Notes	*The following are not changes in accounting policies*: ○ The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of formal retirement gratuity scheme by an employer in place of adhoc ex-gratia payments to employees on retirement. ○ The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

Question 1

Give two examples on each of the following items:

a) Change in Accounting Policy
b) Change in Accounting Estimate
c) Extra Ordinary Items
d) Prior Period Items.

Solution

a) Examples of Changes in Accounting Policy:

(i) Change of method to value fixed assets from Cost to Revaluation model.
(ii) Change in cost formula in measuring the cost of inventories.

b) Examples of Changes in Accounting Estimates:

(i) Change in estimate of provision for doubtful debts on sundry debtors.
(ii) Change in estimate of useful life of fixed assets.

c) Examples of Extraordinary items:

(i) Loss due to earthquakes / fire / strike
(ii) Attachment of property of the enterprise by government

d) Examples of Prior period items:

(i) Applying incorrect rate of depreciation in one or more prior periods.
(ii) Omission to account for income or expenditure in one or more prior periods.

Question 2 *(ICAI Study Material)*

The company finds that the inventory sheets of 31.3.2019 did not include two pages containing details of inventory worth ₹14.5 lakhs. State, how you will deal with the following matters in the accounts of Pure Ltd. for the year ended 31st March, 2020.

Solution

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

Rectification of error in inventory valuation is a prior period item as per AS 5. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

Question 3 *(ICAI Study Material)*

(i) During the year 2019-2020, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?

(ii) A company signed an agreement with the Employees Union on 1.10.2019 for revision of wages with retrospective effect from 30.9.2018. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2019-20?

Solution

(i) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that: "When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately." Circumstances which may give to separate disclosure of items of income and expense in accordance with AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

(ii) It is given that revision of wages took place on 1st October, 2019 with retrospective effect from 30.9.2018. Therefore wages payable for the half year from 1.10.2019 to 31.3.2020 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item. Additional wages liability of ₹ 7,50,000 (for 1½ years @ ₹ 5,00,000 per annum) should be included in current year's wages. It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Such an expense does not qualify as an extraordinary item. However, as per AS 5, 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.

Question 4 *(RTP May 2018)/ (RTP Nov 2022)*

Bela Ltd. has a vacant land measuring 20,000 sq. mts, which it had no intention to use in the future. The Company decided to sell the land to tide over its liquidity problems and made a profit of ₹10 Lakhs by selling the said land. There was a fire in the factory and a part of the unused factory shed valued at ₹ 8 Lakhs was destroyed. The loss from fire was set off against the profit from sale of land and profit of ₹2 lakhs was disclosed as net profit from sale of assets. Do you agree with the treatment and disclosure? If not, state your views.

Solution

As per para 8 of AS 5, Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

In the given case the selling of land to tide over liquidation problems as well as fire in the Factory does not constitute ordinary activities of the Company. These items are distinct from the ordinary activities of the business. Both the events are material in nature and expected not to recur frequently or regularly. Thus, these are Extraordinary Items.

Therefore, in the given case, disclosing net profits by setting off fire losses against profit from sale of land is not correct. The profit on sale of land, and loss due to fire should be disclosed separately in the statement of profit and loss.

Question 5 *(ICAI Study Material)*

From the past 5 financial years, an old outstanding balance of ₹50,000 was still appearing as sundry creditor in the current year balance sheet of People Ltd. The company is certain that this amount is not payable due to one or more reasons. Therefore, it decided to write off the said amount in its current year's books of accounts and recognize it as income. The company treated the amount of ₹ 50,000 written off as a prior period item and made the adjustments accordingly. The company is of the view that since sundry balances were recognized in the prior period(s), its related written-off amount should be treated as a prior period item.

Solution

No, the company is not correct in treating the amount written off as a prior period item.

As per AS 5, prior period items are income or expenses which arise in a current year due to errors or omissions in the preparation of the financial statements of one or more prior period(s). Writing off an old outstanding balance in the current year which is appearing in its books of accounts from the past 5 financial years does not mean that there has been an error or omission in the preparation of financial statements of prior period(s).

It is just a practice adopted by the company to write off the old outstanding balances of more than 5 years in its current year books of accounts. Therefore, the amount written off is not treated as a prior period item. Hence, adjusting the amount ₹50,000 written off as a prior period item on the basis that sundry balances were recognized in prior period(s) is not in line with AS 5.

Question 6 *(RTP Nov 2018) / (RTP Nov 2019) / (RTP Nov 2020) (Similar)/ (RTP May 2022)*

The Accountant of Mobile Limited has sought your opinion with relevant reasons, whether the following transactions will be treated as change in Accounting Policy or not for the year ended 31st March, 2020. Please advise him in the following situations in accordance with the provisions of relevant Accounting Standard;

(a) Provision for doubtful debts was created @ 2% till 31st March, 2019. From the Financial year 2019-2020, the rate of provision has been changed to 3%.

(b) During the year ended 31st March, 2020, the management has introduced a formal gratuity scheme in place of ad-hoc ex-gratia payments to employees on retirement.

(c) Till the previous year the furniture was depreciated on straight line basis over a period of 5 years. From current year, the useful life of furniture has been changed to 3 years.

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

(e) During the year ended 31st March, 2020, there was change in cost formula in measuring the cost of inventories

Solution

(a) In the given case, Mobile limited created 2% provision for doubtful debts till 31st March, 2019. Subsequently in 2019-20, the company revised the estimates based on the changed circumstances and wants to create 3% provision. Thus change in rate of provision of doubtful debt is change in estimate and is not change in accounting policy. This change will affect only current year.

(b) As per AS 5, the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is a transaction which is substantially different from the previous policy, will not be treated as change in an accounting policy.

(c) Change in useful life of furniture from 5 years to 3 years is a change in estimate and is not a change in accounting policy.

(d) Adoption of a new accounting policy for events or transactions which did not occur previously should not be treated as a change in an accounting policy. Hence the introduction of new pension scheme is not a change in accounting policy.

(e) Change in cost formula used in measurement of cost of inventories is a change in accounting policy.

Question 7 *(Inter Jan 2021) (5 Marks) / (RTP May 2023)*

State whether the following items are examples of change in Accounting Policy / Change in Accounting Estimates / Extraordinary items / Prior period items / Ordinary Activity:

(i) Actual bad debts turning out to be more than provisions.
(ii) Change from Cost model to Revaluation model for measurement of carrying amount of PPE.
(iii) Government grant receivable as compensation for expenses incurred in previous accounting period.
(iv) Treating operating lease as finance lease.
(v) Capitalisation of borrowing cost on working capital.
(vi) Legislative changes having long term retrospective application.
(vii) Change in the method of depreciation from straight line to WDV.
(viii) Government grant becoming refundable.
(ix) Applying 10% depreciation instead of 15% on furniture.
(x) Change in useful life of fixed assets.

Solution

(i) Change in Accounting Estimates
(ii) Change in Accounting Policy
(iii) Extra -ordinary Items
(iv) Prior- period Items
(v) Prior-period Items (as interest on working capital loans is not eligible for capitalization)
(vi) Ordinary Activity
(vii) Change in Accounting Estimates
(viii) Extra -ordinary Items
(ix) Prior- period Items
(x) Change in Accounting Estimates

Net Profit or Loss for period, Prior Period Items & Changes in Accounting Policies (AS-5)

Net Profit or Loss for the period

Principle Revenue producing & generating activities

Exceptional Items:

Items of such size, nature or incidence for which disclosure is relevant

Extraordinary Items

Clearly distinct from ordinary activities & not expected to recur frequently

Prior Period Items

Income / expense in current year due to error / omissions in prior periods

Nature & Amount to be separately disclosed to perceive impact on current profit / loss

Change in Accounting Estimates

Meaning: Uncertainities inherent in business activities, many items can only be estimated

When change occur: New information, more experience, Subsequent development, etc.

Note: Not a prior period or extraordinary item
Effect of change classified using same classification as used for estimate

Disclosure: If Material Effect (Current / Subsequent period)

- Quantifiable
  - Disclose nature & amount
- Not Quantifiable
  - Disclose Fact

Change in Accounting Policy

Rule: Accounting policy once adopted should be followed consistently

When change Recommended:

- Required by Statute / Law
- For compliance with AS
- More appropriate presentation of financial statements

Disclosure: Material Effect

- Current
  - Amt. ✓
    - Disclose amount
  - Amt. ✗
    - Disclose Fact
- Later
  - Disclose Fact

PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

AS 29

Liabilities	It is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
Present Obligation	An obligation is a present obligation if based on the evidence available, its existence at the balance sheet date is considered probable i.e. more likely than not (>50%).
Possible Obligation	An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet is considered not probable (< 50%).
PROVISION	
Meaning	A Provision is a liability which can be measured only by using a substantial degree of estimation.
Recognition criteria (PARA 14)	A provision should be recognized when: → An enterprise has a present obligation as a result of past event. → It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation. → And a reliable estimate can be made of the amount of obligation. If these conditions are not met, no provision should be recognized. *Example*: X Ltd sells refrigerators with a warranty of 6 months. The refrigerators would be repaired free of cost by X Ltd. if some problem arises during the next 6 months of sale. There is a present obligation for X Ltd because if some defect arises, X Ltd would need to incur expenses on repairs of the refrigerator. Thus, a provision is required to be made in the books of X Ltd.
Measurement of provisions	Amount recognized as provision should be the best estimate of expenditure required to settle the present obligation at the balance sheet date.
Determinants of best estimate (Illustrative)	❖ Judgement of the management of the enterprise. ❖ Experience of similar transactions ❖ Reports from independent experts ❖ Any additional evidence provided by events after the balance sheet date.
Notes	❖ Provision should not be recognized for future operating losses. ❖ Provision should be measured before tax ❖ Provision should not be discounted to its present value. *Exception*: Discounting of provision for decommissioning, restoration and similar liabilities should be done as per the pre-tax discount rate as mentioned therein. ❖ Provision should be reviewed at each balance sheet date ❖ It should be adjusted to reflect the current best estimate ❖ If it is no longer probable that there will be outflow of resources, then provision should be reversed.

CONTINGENT LIABILITY

Meaning	It is : → A <u>possible obligation</u> that arises from past events and the existence of which will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not wholly within the control of the enterprise *<u>OR</u>* → A <u>present obligation</u> that arises from past events <u>but is not recognized</u> because ➢ it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation OR ➢ A reliable estimate of the amount of the obligation cannot be made.

Elements		Cases				
1.	Possible obligation	X	X	X	X	√
2.	Present obligation from past events	√	√	√	√	NA
3.	Expected outflow	√	√	X	X	NA
4.	Measurability (using substantial degree of estimation)	√	X	√	X	NA
5.	Whether it is Provision(P) or Contingent liability (CL)	P	CL	CL	CL	CL

Recognition	Contingent liability should not be recognized
Disclosure	Contingent liability should be disclosed <u>Exception:</u> The possibility of an outflow of resources embodying economic benefits is remote (i.e. no disclosure is even required in such case).

CONTINGENT ASSETS

Meaning	It is a <u>possible asset</u> that arises from past events the existence of which will be confirmed only by the <u>occurrence or non-occurrence</u> of one or more uncertain future events not wholly within the control of an enterprise.
Recognition	A contingent asset <u>should not be recognized</u>. <u>Note:</u> When the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
Disclosure	❖ Contingent asset <u>should not be disclosed in the financial statements</u> ❖ It is <u>disclosed in the director's report</u>.

REIMBURSEMENT

Meaning	When some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (example through insurance contracts, indemnity clauses, supplier's warranty etc.), reimbursement should be recognized when and only when it is <u>virtually certain</u> that <u>reimbursement will be received</u> if the enterprise settles the obligation.
Valuation & Disclosure	❖ Reimbursement recognized should not exceed the amount of provision. ❖ In Balance Sheet, reimbursement should be presented as a separate asset. ❖ In the Statement of P&L, provision may be presented net of the amount recognized for reimbursement.

RESTRUCTURING

Meaning	A restructuring is a programme that is planned and controlled by management, and materially changes either: (a) the scope of a business undertaken by an enterprise; or (b) the manner in which that business is conducted
Examples	❖ sale or termination of a line of business; ❖ the closure of business locations in a country or region or the relocation of business activities from one country or region to another; ❖ changes in management structure, for example, eliminating a layer of management; and ❖ fundamental re-organizations that have a material effect on the nature and focus of the enterprise's operations.
Whether provision required?	➢ A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in Para 14 are met. ➢ No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.
Inclusions & Exclusions	A restructuring provision should include only the direct expenditures arising from the restructuring which are those that are both: (a) necessarily entailed by the restructuring; and (b) not associated with the ongoing activities of the enterprise. A restructuring provision does not include such costs as: (a) retraining or relocating continuing staff; (b) marketing; or (c) investment in new systems and distribution networks.

ONEROUS CONTRACT

Meaning	It is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the *lower* of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.
Example	An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2020 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user. Present obligation as a result of a past obligating event- The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation. An outflow of resources embodying economic benefits in settlement- When the lease becomes onerous, an outflow of resources embodying economic benefits is probable *Conclusion*-A provision is recognised for the best estimate of the unavoidable lease payments.

Question 1 *(Inter Nov 2022) (5 Marks)*

At the end of the financial year ending on 31st March, 2022, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

Particulars	Probability	Loss (₹)
In respect of five cases (Win)	100%	-
Next ten cases (Win)	50%	-
Lose (Low damages)	40%	12,00,000
Lose (High damages)	10%	20,00,000
Remaining five cases (Win)	50%	-
Lose (Low damages)	30%	10,00,000
Lose (High damages)	20%	21,00,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof as per AS - 29.

Solution:

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

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

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

Expected loss in next ten cases = 40% of ₹ 12,00,000 + 10% of ₹ 20,00,000
= ₹ 4,80,000 + ₹ 2,00,000
= ₹ 6,80,000
Expected loss in remaining five cases = 30% of ₹ 10,00,000 + 20% of ₹ 21,00,000
= ₹ 3,00,000 + ₹ 4,20,000
= ₹ 7,20,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of 1,04,00,000 (₹ 6,80,000 x 10 + ₹ 7,20,000 x 5) as contingent liability.

Question 2 *(Inter Nov 2019) (5 Marks) / (RTP May 2023)*

A Ltd. provides after sales warranty for two years to its customers. Based on past experience, the company has the following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period.

Less than 1 year: 2% provision More than 1 year: 3% provision

The company has raised invoices as under:

Invoice Date	Amount (₹)
11th February, 2018	60,000
25th December, 2018	40,000
4th October, 2019	1,35,000

Calculate the provision to be made for warranty under AS-29 as at 31st March, 2019 and 31st March, 2020. Also compute amount to be debited to P & L account for the year ended 31st March, 2020.

Solution

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

As at 31st March, 2019 = ₹ 60,000 x .02 + ₹ 40,000 x .03
= ₹ 1,200 + ₹ 1,200
= ₹ 2,400

As at 31st March, 2020 = ₹ 40,000 x .02 + ₹ 1,35,000 x .03
= ₹ 800 + ₹ 4,050
= ₹ 4,850

Amount debited to Profit and Loss Account for year ended 31st March, 2020

Balance of provision required as on 31.03.2020	4,850
Less: Opening Balance as on 1.4.2019	(2,400)
Amount debited to profit and loss account	2,450

Note: No provision will be made on 31st March, 2020 in respect of sales amounting ₹ 60,000 made on 11th February, 2018 as the warranty period of 2 years has already expired.

Question 3 *(ICAI Study Material / (RTP May 2021)*

AB Ltd. is in the process of finalizing its account for the year ended 31st March, 2020. The company seeks your advice on the following:

The company's sale tax assessment for assessment year 2017-18 has been completed on 14th February, 2020 with a demand of ₹ 5.40 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 ₹ 3.70 crore.

Solution

Since the company is not appealing against the addition of ₹ 1.70 crore (₹ 5.40 crore less ₹ 3.70 crore), therefore, the same should be provided/ expensed off in its accounts for the year ended on 31st March, 2020. However, the amount paid under protest can be kept under the heading 'Long-term Loans & Advances / Short-term Loans and Advances' as the case may be along with disclosure as contingent liability of ₹ 3.70 crore.

Question 4

During 2018-19, A Ltd. gives a guarantee of certain borrowings of B Ltd., whose financial condition at that time is sound. During 2019-20, the financial condition of B Ltd. deteriorates and at 30 September 2019, B Ltd. goes into liquidation.
State whether a provision is required
(a) At 31 March 2019 (b) At 31 March 2020

Solution
(a) At 31 March 2019
Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.
An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2019.
Conclusion - No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

(b) At 31 March 2020
Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.
An outflow of resources embodying economic benefits in settlement - At 31 March 2020, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
Conclusion - A provision is recognised for the best estimate of the obligation.

Question 5

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2020. The enterprise has not fitted the smoke filters.
State whether a provision is required:-
(a) At the balance sheet date of 31 March 2020
(b) At the balance sheet date of 31 March 2021

Solution
(a) At 31 March 2020
Present obligation as a result of past obligating event-There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.
Conclusion - No provision is recognised for the cost of fitting the smoke filters.

(a) At 31 March 2021
Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).
An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.
Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

Question 6 *(ICAI Study Material)*

Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 2019-20 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2020-21 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2019-20 financial year. As on balance sheet date (31.3.2020), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.
(i) Should Sun Ltd. provide for contingency as per AS 29?
(ii) Should provision be measured as the excess of compensation to be paid over the profit?

Solution

(i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting ₹ 1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2020 and no profit had accrued for the financial year 2019-2020. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.5 crores.

Question 7 *(RTP May 2018) / (RTP Nov 2019)*

The company has not made provision for warrantee in respect of certain goods considering that the company can claim the warranty cost from the original supplier. Hence the accountant of the company says that the company is not having any liability for warrantees on a particular date as the amount gets reimbursed. You are required to comment on the accounting treatment done by the XYZ Ltd. in line with the provisions of AS 29. Comment

Solution

As per AS 29, where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

It is apparent from the question that the company had not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. However, the provision for warranty should have been made as per AS 29 and the amount claimable as reimbursement should be treated as a separate asset in the financial statements of the company rather
than omitting the disclosure of such liability. Accordingly, it was viewed that the accounting treatment adopted by the company with respect to warranty is not correct.

Question 8 *(Inter Nov 2020) (5 Marks) / (RTP Nov 2023)*

With reference to AS 29, how would you deal with the following in the Annual Accounts of the company at the Balance Sheet date:

(i) The company operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Eighty five percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and fifteen percent arise through the extraction of oil. At the balance sheet date, rig has been constructed but no oil has been extracted.

(ii) The Government introduces a number of changes to the taxation laws. As a result of these changes, the company will need to train a large proportion of its accounting and legal workforce in order to ensure continued compliances with tax law regulations. At the balance sheet date, no retraining of staff has taken place

Solution

(i) The construction of the oil rig creates an obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil. An outflow of resources embodying economic benefits in settlement is probable. Thus, a provision is recognized for the best estimate of 85% of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it. These costs are included as part of the cost of the oil rig.

However, there is no obligation to rectify the damage that will be caused by extraction of oil, as no oil has been extracted at the balance sheet date. So, no provision is required for the cost of extraction of oil at balance sheet date. 15% of costs that arise through the extraction of oil are recognized as a liability when the oil is extracted.

(ii) As per AS 29, a provision for restructuring costs is recognized only when the recognition criteria for provisions are met. A restructuring provision does not include costs as of retraining or relocating continuing staff. The expenditures of training the staff related to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognized on the same basis as if they arose independently of a restructuring. At the balance sheet date, no such expenditure has been incurred hence no provision is required.

Question 9 *(RTP May 2022)/ (RTP Nov 2022) (Similar)*

Chaos Limited is in the process of finalizing its accounts for the year ended 31st March, 2020. It seeks your advice in the following cases:

(i) Chaos Limited has filed court case in 2014-2015 against its competitors. It became evident to its lawyers during the year ended 31st March, 2020 that Chaos Limited may lose the case and would have to pay ₹ 3,00,000 being the cost of litigation. No entries/provisions have been made in the books.

(ii) A new regulation has been passed in 2019-2020 by the healthcare ministry to upgrade facilities. Deadline set by the government is 31.03.2021. The company estimates an expenditure of ₹ 10,00,000 for the said upgrade.

(iii) The company gives one year warranty for its healthcare equipment under the contract of sale that it will make good any manufacturing defect by repair or replacement. As per past experience, it is probable that there will be 1% such cases and estimated cost of repair / replacement is estimated at 10% of such sale value. During the year, the company has made a sale of ₹ 5 crores.

Kindly give your answer for each of above with proper reasoning according to the relevant Accounting Standard. Also state the principles for recognition of provision, as per AS 29.

Solution

Principles for recognition of provisions: As per AS 29, "a provision shall be recognised when:

a) an entity has a present obligation (legal or constructive) as a result of a past event;

b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

c) a reliable estimate can be made of the amount of the obligation.

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

Accounting treatment under the given scenarios:

(i) On 31st March, 2020, since it is evident to the lawyer that Chaos Limited may lose the case and also a reliable estimate of the outflow can be made as ₹ 3,00,000, there is a present obligation. Hence, provision should be recognised for ₹ 3,00,000 for the amount which may be required to settle the obligation.

(ii) Under new regulation, an entity is required to upgrade its facilities by 31st March, 2021. However, on 31st March, 2020, i.e. at the end of the reporting period, there is no obligation because there is no obligating event either for the costs of upgrading the facilities or for fines under the regulations. Hence, no provision should be recognized on 31st March, 2020 for upgrading the facilities by 31st March, 2021.

(iii) The obligating event is the sale of health care equipment with a warranty, which gives rise to a legal obligation. Here, an outflow of resources embodying economic benefits in settlement is probable for the warranties as a whole. Hence, a provision is recognized for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period as follows:

Probability of warranty cases for the entity where repair/replacement may be required as per past experience = 1% of ₹ 5,00,00,000 = ₹ 5,00,000

Provision, Contingent Liabilities & Contingent Assets (AS-29)

Provision

Recognition

- Present obligation from past events
- Expected outflow of resources
- Reliable estimate can be made

Contingent Liability

- Possible obligation

Or

- Present obligation but not recognised b'coz
  - Outflow not probable

    Or
  - Reliable estimate cannot be made

Recognition : No

Disclosure : Yes

Exception : Remote possibility

Contingent Asset

Possible asset from past events, existence confirmed only by future events.

Disclosure :

Not in financial statements

Disclosure in Director's Report

Reimbursement

Recognise: when virtually certain

- Separate asset in B/s
- Provision net of Reimbursement in P&L A/c

Restructuring

Programme that is planned & controlled by management & materially changes either :

- scope of business
- manner in which business conducted

Make provision if recognition criteria met

Onerous Contract

Unavoidable costs of meeting obligation under contract exceed economic benefits

Provision : Lower of

- Cost of fulfilling contract
- Penalty from failure to fulfill it

AS -2: VALUATION OF INVENTORIES

Meaning of Inventories	These are the assets: → Held for sale in the ordinary course of business (Finished goods/Stock in trade) → In the process of production for such sale (Work –in-Progress) → In the form of material or supplies to be consumed in the production process or in the rendering of services (raw material, stores and spares*, etc.) ** Inventories do not include spare parts, servicing equipment & standby equipment which meet the definition of property, plant and equipment as per AS 10. Such items are accounted for in accordance with AS 10.*
***Measurement* (PARA 5)**	**Inventories should be valued at lower of cost and net realizable value**

Cost of Inventories

Cost of Purchase

Conversion cost

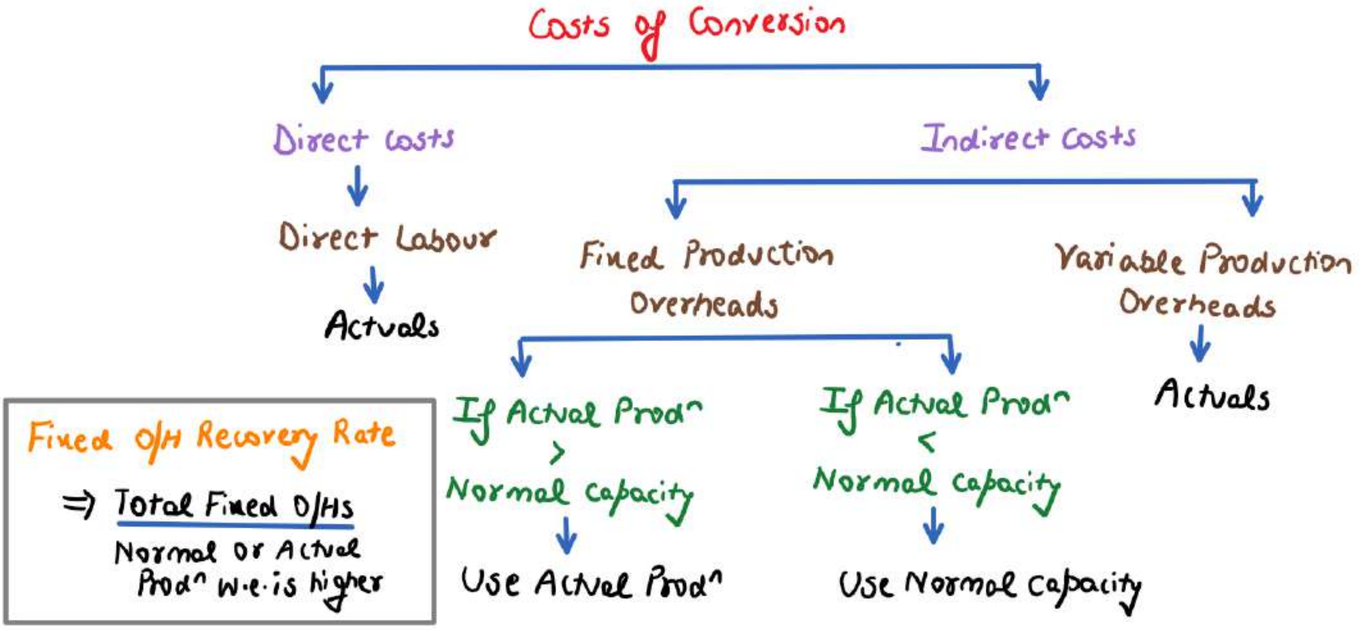
Other cost incurred in bringing the inventory to their present location and condition

A. COST OF PURCHASE

Basic Purchase Price		XX
Add	Duties and Taxes (non refundable)	XX
Add	Freight inwards	XX
Add	Other expenditure directly attributable to the acquisition (Note)	XX
Less	Trade discount and rebates	(XX)
	Cost of Purchase	XX

Note: Examples of expenditure directly attributable for purchases are- (a) Costs of Containers (b) Transit Insurance, (c) Buying Commission where purchase of material is possible only through buying agents

B. COST OF CONVERSION

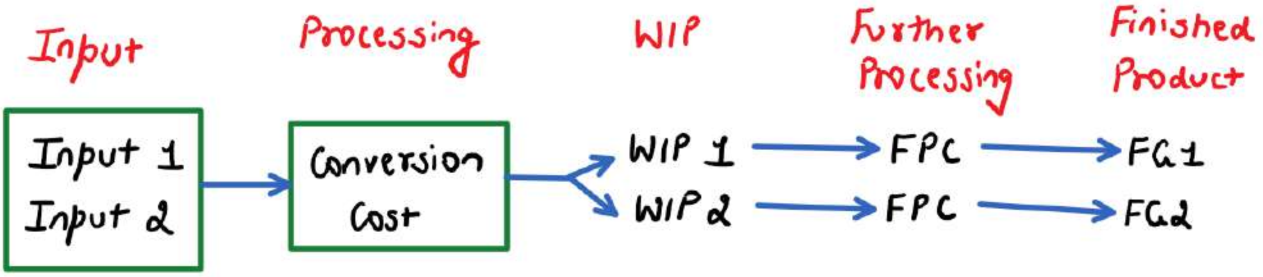


COST OF CONVERSION (NOT SEPARATELY IDENTIFIABLE) IN CASE OF PRODUCTION PROCESS RESULTING IN MORE THAN ONE PRODUCT BEING PRODUCED SIMULTANEOUSLY

CASE 1: JOINT PRODUCT:

When the cost of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis.

Allocation may be based for e.g., Relative sales value of each product either at the stage in production process when the products become separately identifiable or at the completion of production.



Basis of Allocation of Conversion Cost

At the stage in Production process	At the completion of Production
↓	↓
On the relative sales value of WIP 1 and WIP 2	On the relative sales value of FG 1 and FG 2

Example:

Total cost = 300000
(Material + wages + O/HS)

	Units	S.P.
FG 1	3000	160
FG 2	2000	60

	FG 1	FG 2
Sales value of Units produced	480000 (3000 X 160)	120000 (2000 X 60)
Ratio	4 :	1
Costs Allocated (300000 in 4:1)	240000 :	60000
No. of units	3000	2000
Cost per unit	80	30

CASE 2: MAIN PRODUCT AND BY PRODUCT:

- Most by products as well as scrap or waste materials, by their nature are immaterial.
- In such a case, they are measured at NRV and such value is deducted from the cost of main product.

C. OTHER COST

Other costs are included in cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

Example: Cost of designing products for specific customers.

EXCLUSIONS FROM THE COST OF INVENTORIES *(PARA 13)*

- Abnormal amount of wasted materials, labour or other production cost (Abnormal loss)
- Storage cost unless those are necessary in the production process prior to a further production stage.
- Administrative overheads that do not contribute to bringing the inventories to their present location and condition.
- Selling and distribution cost
- Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are therefore usually not included in cost of inventory ***(Para 12)***

COST FORMULAS

For items that are not ordinarily interchangeable	*For other items*
Specific identification of cost method: Specific costs are attributed to identified items of inventory	FIFO: Inventory which were purchased or produced first are sold or consumed first. or Weighted Average method: Weighted average of cost of similar items

TECHNIQUES FOR MEASUREMENT OF COST

(May Be Used For Convenience if Results Approximate Actual Cost)

Standard Cost method	*Retail method*
Takes into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilization	• Often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins. • Inventory is determined by reducing from sales value of inventory the appropriate GP %

NET REALISABLE VALUE (NRV)

Estimated Selling Price	XX
Less: Estimated selling expenses	(XX)
Less: Estimated cost of completion	(XX)
NRV	**XX**

- ❖ NRV is to be seen on each and every balance sheet date.
- ❖ Inventories should be usually written down to NRV on an item by item basis (individual basis) and not on global basis.
- ❖ In case of firm/committed contract of sale, NRV shall be calculated at the contract price.

Example:

	Cost	NRV	Lower
Product A	50	40	40
Product B	60	80	60
			100

Example: Closing stock: 3000 units

Cost = 40 S.P. = 50

Firm Contract for 1000 units @ 35/unit

Units	Cost	NRV	Lower	Value
1000	40	35	35	35000
2000	40	50	40	80000
				115000

VALUATION OF MATERIALS AND OTHER SUPPLIES *(PARA 24)*

If finished product in which such raw material is to be used is expected to be sold at or above cost price [SP $_{FG}$ ≥ CP$_{FG}$]	Other cases [SP $_{FG}$ < CP$_{FG}$]
Value Raw Material at Cost Price.	Value Raw Material at Lower of Cost price or Replacement price [CP or RP ↓]

Valuation of Inventories (AS-2)

- Raw Material
  - $SP_{FG} \geq CP_{FG}$ → Cost Price
  - $SP_{FG} < CP_{FG}$ → Cost or Replacement Price w.e. is lower
- WIP & Finished Goods
  - Cost
    - Standard Cost → On Normal consumption (Regular Review)
    - Retail Price → Sales value of Inventory (−) GP(%)
    - Actual Cost → *
  - NRV (Net Realisable value)
    - Estimated Selling Price
    - (−) Estimated selling Expenses
    - (−) Estimated costs of completion

*Actual Cost

- Direct Material
  - General Identification
    - FIFO
    - Weighted Average
  - Specific Identification
- Conversion Costs
  - Direct Costs
    - Direct Labour → Actuals
  - Indirect Costs
    - Fixed Overheads → Normal capacity or Actual Prod^n ↑
    - Variable Overheads → Actuals
  - Joint Cost
    - Joint / Main
      - Sales value at Separation
      - Sales value at completion
    - By Product → At NRV Deduction from cost
- Other Costs

⇒ Purchase costs

Basic Purchase Price
+ Non Refundable Taxes
+ Freight Inwards
+ Directly Attributable Exp.

⇒ Exclusions from Cost

Storage costs, Selling & Distribution costs, Abnormal Loss, Administrative O/Hs, Interest & other Borrowing costs

Question 1

The closing inventory at cost of XYZ Ltd. amounted to ₹ 9,56,700. 350 Shirts, which had cost ₹ 380 each and normally sold for ₹ 750 each are included in this amount of ₹ 9,56,700. Owing to a defect in manufacture, they were all sold after the Balance Sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds. What should be the closing inventory value?

Solution

Calculation of value of closing inventory

Value of closing inventory (given)	9,56,700
Less: Adjustment to bring the stock of shirts at NRV (W.N 1)	(8,313)
Revised value of closing inventory as per AS 2	9,48,387

Working Notes 1: Valuation of Shirts as per AS 2

Cost price (per shirt)	380
NRV per shirt :	
Sale price (per shirt) ₹ 750 × 50% = 375.00	
Less: Selling expenses (5% of ₹ 375) = (18.75)	
NRV (per shirt) = 356.25	356.25
As per AS 2, inventories are valued at cost or NRV whichever is less	356.25
Difference of cost and NRV	**23.75**
Therefore, value of inventory of shirts to be reduced by ₹ 8,313 (approx) (₹ 23.75 x 350 shirts)	

Question 2

An enterprise ordered 13000 kg of certain material at Rs. 90 per unit. The purchase price includes GST at Rs. 5 per kg, in respect of which full credit is admissible. Freight incurred amounted to Rs. 80,600. Normal transit loss is 4%. The enterprise actually received 12,400 Kg and consumed 10,000 Kg. What is the cost of inventory.

Solution

Purchase price (13,000 Kg. x Rs. 90)	11,70,000
Less: GST Credit (13,000 Kg. x Rs. 5)	(65,000)
	11,05,000
Add: Freight	80,600
Total material cost	**11,85,600**
Number of units normally received = 96% of 13,000 Kg.	12,480 kg
Normal cost per Kg. (11,85,600/12,480)	**95**

	Kg	**Rs. /Kg.**	**Rs.**
Materials consumed	10,000	95	9,50,000
Cost of inventory	2,400	95	2,28,000
Abnormal loss	80	95	7,600
Total material cost	**12,480**		**11,85,600**

Note: Abnormal losses are recognised as separate expense in the Profit & Loss Account

Question 3

A Limited is engaged in manufacturing of Chemical Y for which Raw Material X is required. The company provides you following information for the year ended 31st March, 2021.

	Rs. per unit
Raw material X	
Cost price	380
Unloading charges	20

Freight inward	40
Replacement cost	300
Chemical Y	
Material consumed	440
Direct labour	120
Variable overhead	80

Additional Information:

(i) Total fixed overhead for the year was Rs. 4,00,000 on normal capacity of 20,000 units.
(ii) Closing balance of Raw Material X was 1,000 units and Chemical Y was 2,400 units.

You are required to calculate the total value of closing stock of Raw Material X and Chemical Y according to AS 2, when

(a) Net realizable value of Chemical Y is Rs. 800 per unit
(b) Net realizable value of Chemical Y is Rs. 600 per unit

Solution

(a) When Net Realizable Value of the Chemical Y is Rs. 800 per unit

NRV is greater than the cost of Finished Goods Y i.e. Rs. 660 (Refer W.N.)

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

Value of Closing Stock:

	Qty.	**Rate**	**Amount**
Raw Material X	1,000	440	4,40,000
Finished Goods Y	2,400	660	15,84,000
Total Value of Closing Stock			**20,24,000**

(b) When Net Realizable Value of the Chemical Y is Rs. 600 per unit

NRV is less than the cost of Finished Goods Y i.e. Rs. 660.

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

Value of Closing Stock:

	Qty.	**Rate**	**Amount**
Raw Material X	1,000	300	3,00,000
Finished Goods Y	2,400	600	14,40,000
Total Value of Closing Stock			**17,40,000**

Working Note:

Statement showing cost calculation of Raw material X and Chemical Y

Raw material X	**Rs. per unit**
Cost price	380
Add: Unloading charges	20
Add: Freight inward	40
Cost	**440**
Chemical Y	**Rs. per unit**
Material consumed	440
Direct labour	120
Variable overhead	80
Fixed overheads (4,00,000/20,000)	20
Cost	**660**

Question 4 Inter Jan 2021 (5 Marks)

Mr. Jatin gives the following information relating to the items forming part of the inventory as on 31.03.2021. His enterprise produces product P using Raw Material X.

(i) 900 units of Raw Material X (purchases @ ₹ 100 per unit). Replacement cost of Raw Material X as on 31.03.2021 is ₹ 80 per unit

(ii) 400 units of partly finished goods in the process of producing P. Cost incurred till date is ₹ 245 per unit. These units can be finished next year by incurring additional cost of ₹ 50 per unit.

(iii) 800 units of Finished goods P and total cost incurred is ₹ 295 per unit.

Expected selling price of product P is ₹ 280 per unit, subject to a payment of 5% brokerage on selling price.

Determine how each item of inventory will be valued as on 31.03.2021. Also calculate the value of total Inventory as on 31.03.2021.

Solution

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at cost or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. In the given case, selling price of product P is ₹ 266 and total cost per unit for production is ₹ 295.

Hence the valuation will be done as under:

(i) 900 units of raw material X will be written down to replacement cost as market value of finished product is less than its cost, hence valued at ₹ 80 per unit.

(ii) 400 units of partly finished goods will be valued at 216 per unit i.e., lower of cost (₹ 245) or Net realizable value ₹ 216 (Estimated selling price ₹ 266 per unit less additional cost of ₹ 50).

(iii) 800 units of finished product P will be valued at NRV of ₹ 266 per unit since it is lower than cost ₹ 295.

Particulars	**Units**	**Cost (₹)**	**NRV/ Replacement cost ₹**	**Value = units x cost or NRV whichever is less (₹)**
Raw material X	900	100	80	72,000
Partly finished goods	400	245	216	86,400
Finished goods P	800	295	266	2,12,800
Value of Inventory				**3,71,200**

Question 5 Inter July 2021 (5 Marks)

Joy Ltd. purchased 20,000 kilograms of Raw Material @ ₹ 20 per kilogram during the year 2020-21. They have furnished you with the following further information for the year ended 31st March, 2021:

Particulars	**Units**	**Amount (₹)**
Opening Inventory:		
Finished Goods	2,000	1,00,000
Raw Materials	2,200	44,000
Direct Labour		3,06,000
Fixed Overheads		3,00,000
Sales	20,000	11,20,000
Closing Inventory:		
Finished Goods	2,400	
Raw Materials	1,800	

The plant has a capacity to produce 30,000 Units of finished product per annum. However, the actual production of finished products during the year 2020-21 was 20,400 Units. Due to a fall in the market

demand, the price of the finished goods in which the raw material has been utilized is expected to be sold @ ₹ 40 per unit. The replacement cost of the raw material was ₹ 19 per kilogram.
You are required to ascertain the value of closing inventory as at 31st March, 2021 as per AS 2.

Solution

Statement Showing the Computation of Value of Closing Inventory

Value of Closing Finished Goods

Particulars	Amount (₹)
Cost of Raw Material consumed (20,400 units X ₹ 20 per kg)	4,08,000
Direct Labour	3,06,000
Fixed Overheads (3,00,000/30,000 x 20,400)	2,04,000
Cost of Production	**9,18,000**
Cost of Closing Inventory of Finished Goods per unit (9,18,000/20,400)	45
Net Realizable Value (NRV) per unit	40

Since net realizable value is less than cost, closing inventory of Finished Goods will be valued at ₹ 40 per unit

Value of Closing Raw Materials

As NRV of finished goods is less than its cost, the relevant raw material will be valued at its replacement cost, which is the best available measure of its NRV i.e. @ ₹ 19 per kg.
Therefore, value of closing inventory would be as under:

Finished Goods 2,400 units @ ₹ 40/- per unit	₹ 96,000
Raw Materials 1,800 kg @ ₹ 19/- per kg	₹ 34,200
Total	**₹ 1,30,200**

Working Note:

Calculation of raw material consumed during the year

Particulars	Unit (Kg)
Opening Inventory	2,200
Purchases	20,000
Less: Closing Inventory	(1,800)
Raw Material Consumed	20,400

AS-10: PROPERTY, PLANT & EQUIPMENT

Property, Plant & Equipment (AS-10)

Meaning

Tangible items that are
- held for use in prodⁿ/supply/rental/administrative purposes
- & expected use > 1 Year

Non Applicability
- Biological assets (living animal/plant) Other than Bearer plant*
- Wasting Assets

* • used in prodⁿ/supply of agricultural produce
• Expected > 12 Months
• Remote chances of being sold as agricultural produce

Recognition criteria

Cost to be recognised as asset if
- Future Economic benefits will flow
- Cost can be reliably measured

Note: May be appropriate to aggregate individually insignificant items.

Spare Parts/Standby Eq./Servicing Eq.
[Whether definition of PPE met]
- Yes: Apply AS10
- No: Apply AS2

Subsequent costs

- Day to Day Servicing
  Described as Rep. & Maint. Exp. Recognised in P&L A/c
- Replacement of Parts
  - Old Part → DeRecognise
  - New Part → Recognise if criteria met
- Regular Major Inspections
  - Previous Insp. → DeRecognise
  - New Insp. → Recognise if criteria met

Measurement of PPE

Initial Recognition (Cost Model)

Direct Purchase

INCL.
Purchase Price
\+ Non Refundable Taxes
\+ Directly Attributable costs (Site Prep., Installation, Prof. fees)
\+ Decommissiong, Restoration & Liab.

EXCL.
- Cost of opening New Facility
- Cost of Introducing New Prod./Service
- Cost of Staff Training
- Cost of Relocating

Self Constructed

Internal Profits eliminated

Special cases
1) Deferred credit
   Total Payment - Cash Price
   Recognised as interest
2) Exchange
   Measured at Fair value unless
   - F.V. not measurable
   - Transⁿ lacks commercial substance
   → Measured at carrying Amt. of Asset given
3) Consolidated Price
   Apportioned on Fair value basis

Subsequent Recognition

Choose Either
- Cost Model
- Revaluation Model

Apply to Entire class of PPE
(Assets of similar nature & use)

Revaluation Frequency
- Significant & volatile changes in Fair value → Annual
- Insignificant → Interval of 3-5 years

Exchange

Ex:1

Acquire	Give
Old P&M	Equity shares of company (FV=10 MP=30) No: 10000

Value = 10000 X 30 = 300000

Ex:2

Acquire	Give
New P&M (Fair value = 400000)	Equity shares of company (Unlisted)

Value = 400000

Ex:2

Acquire	Give
New P&M (Fair value = 400000)	Equity shares of company No. 10000 (FV=10 MP=30)

Value = 3L/4L w.e. is more clearly evident

Ex:4

Acquire	Give
Old P&M ~~FV~~	Old car ~~FV~~ (Book value = 200000)

Value = 200000

Ex:5

Acquire	Give
Car X (FV= 6L)	Car Y (FV= 7L) (Book value = 680000)

Transaction lacks Commercial Substance.

Value = 680000

Revaluation : Accounting Treatment

First Revaluation

Upward
Use
Revaluation surplus (R/S)

Downward
Use
P&L A/c

Method 1:
Proportionate Increase in both cost & Acc. Dep.

PPE A/c - Dr.
To Acc. Dep. A/c
To Rev. surplus A/c

Method 2:
Acc. Dep. is eliminated & balance through cost

Acc. Dep. A/c - Dr
PPE A/c - Dr
To Rev. surplus A/c

Subsequent Revaluation

Ist	Use	IInd	Use
↑	R/S	↑	R/S
↓	P&L	↓	P&L
↑	R/S	↓	R/S & then P&L
↓	P&L	↑	P&L & then R/S

Transfer of Rev. surplus to Revenue Reserve

During use of Asset
Some may be tfd. as
Dep. (on Revalued Amt.)
(-) Dep. (on original cost)

When asset is derecognised
Whole surplus is transferred

Example:

Original cost = 500000
Acc. Depreciation = 100000

Revalued at 720000

Method 1

	Before Rev.	Increase	After Rev.
Cost	500000	400000	900000
Acc. Dep.	(100000)	(80000)	(180000)
Net/Book Value	400000	320000	720000

Asset 400000
To Acc. Dep. 80000
To Rev. Surplus 320000

Method 2:

Acc. Dep. – Dr 100000
Asset – Dr 220000
To Rev. Surplus 320000

OR

Acc. Dep. 100000
To Asset 100000
Asset 320000
To Rev. Surplus 320000

Depreciation

Meaning: Systematic allocation of depreciable amount of asset over its useful life.

Component Method: Each part of PPE that is significant in relation to total cost of item should be depreciated separately. E.g.: Airframe & Engine of Aircraft

Depreciable Amount: Cost / Revalued Amount – Residual value

Useful life: On the basis of Period: Period over which asset is expected to be used
On the basis of Units: No. of units expected to be obtained.

Commencement: When asset is available for use.

Cessation of Dep.: ① Asset's Residual value ≥ Carrying Amount
② Earlier of
- Asset retired from active use & held for disposal
- Asset is derecognised

Depreciation Method

Method should reflect pattern in which future economic benefits are expected to be consumed by the enterprise.

Straight Line Method

$$\frac{\text{Cost - Residual value}}{\text{Useful life}}$$

OR

Original cost X Rate (%)

Diminishing Balance / WDV Method

Opening WDV × Rate (%)

Units of Production Method

$$\text{Depreciable Amt.} \times \frac{\text{Prod}^{n} \text{ in current Year}}{\text{Total estimated Prod}^{n}}$$

Review of Depreciation Method: Change in Accounting Estimate (Prospective Effect)

Review of Residual value & useful life: Change in Accounting Estimate (Prospective Effect)

Change in Historical cost: Cost may undergo subsequent changes due to exchange rate fluctuations, Price Adjustments, Change in Duties, etc.
(Included in cost of Asset – Prospective Effect)

Land & Buildings: separable assets & accounted separately even when acquired together

Land: Whether Depreciable

No since unlimited useful life.

Exception: If Land has limited useful life.

Retirement: Asset retired from active use & held for disposal

Recorded at Lower of Carrying Amt. or NRV.

Expected loss to be immediately recognised

Derecognition: On Disposal by sale / donation OR when no future benefits expected

Profit / Loss on it to be transferred to P&L A/c

Question 1

Neon Enterprise operates a major chain of restaurants located in different cities. The company has acquired a new restaurant located at Chandigarh. The new-restaurant requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the restaurant will be closed. Management has prepared the following budget for this period –

Salaries of the staff engaged in preparation of restaurant before its opening Rs. 7,50,000
Construction and remodelling cost of restaurant Rs. 30,00,000

Explain the treatment of these expenditures as per provisions of AS 10 "Property, Plant and Equipment".

Solution

As per provisions of AS 10, any cost directly attributable to bring the assets to the location and conditions necessary for it to be capable of operating in the manner indicated by the management are called directly attributable costs and would be included in the costs of an item of PPE.

Management of Neon Enterprise should capitalize the costs of construction and remodelling the restaurant, because they are necessary to bring the restaurant to the condition necessary for it to be capable of operating in the manner intended by management. The restaurant cannot be opened without incurring the construction and remodelling expenditure amounting Rs. 30,00,000 and thus the expenditure should be considered part of the asset.

However, the cost of salaries of staff engaged in preparation of restaurant Rs. 7,50,000 before its opening are in the nature of operating expenditure that would be incurred if the restaurant was open and these costs are not necessary to bring the restaurant to the conditions necessary for it to be capable of operating in the manner intended by management. Hence, Rs. 7,50,000 should be expensed.

Question 2

ABC Ltd. is installing a new plant at its production factory. It provides you the following information:

Cost of the plant (cost per supplier's invoice plus taxes)	31,25,000
Estimated dismantling costs to be incurred after 5 years	2,50,000
Initial Operating losses before commercial production	3,75,000
Initial delivery and handling costs	1,85,000
Cost of site preparation	4,50,000
Consultants used for advice on the acquisition of the plant	6,50,000

Please advise ABC Ltd. on the costs that can be capitalised for plant in accordance with AS 10: Property, Plant and Equipment.

Solution

According to AS 10 on Property, Plant and Equipment, the costs which will be capitalized by ABC Ltd. are as follows:

Cost of the plant (cost per supplier's invoice plus taxes)	31,25,000
Estimated dismantling costs to be incurred after 5 years	2,50,000
Initial delivery and handling costs	1,85,000
Cost of site preparation	4,50,000
Consultants used for advice on the acquisition of the plant	6,50,000
	46,60,000

Note: Operating losses before commercial production amounting to Rs. 3,75,000 will not be capitalized as per AS 10. They should be written off to the Statement of Profit and Loss in the period they are incurred.

Question 3

Shrishti Ltd. contracted with a supplier to purchase machinery which is to be installed in its Department A in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were Rs. 1,41,870. These activities were supervised by a technician during the entire period, who is employed for this purpose of Rs. 45,000 per month. The technician's services were given by Department B to Department A, which billed the services at Rs. 49,500 per month after adding 10% profit margin.

The machine was purchased at Rs. 1,58,34,000 inclusive of IGST @ 12% for which input credit is available to Shrishti Ltd. Rs. 55,770 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of Rs. 30,000 to supervise machinery installation at the factory site.

Ascertain the amount at which the Machinery should be capitalized under AS 10 considering that IGST credit is availed by the Shristhi Limited. Internally booked profits should be eliminated in arriving at the cost of machine.

Solution

Particulars		Amount
Purchase Price	Given (158,34,000 x 100/112)	1,41,37,500
Add: Site Preparation Cost	Given	1,41,870
Technician's Salary	Specific/Attributable overheads for 3 months (45,000 x3)	1,35,000
Initial Delivery Cost	Transportation	55,770
Professional Fees for Installation	Architect's Fees	30,000
Total Cost of Asset		**1,45,00,140**

Question 4 RTP May 2020

The following items are given to you:

ITEMS

(1) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment);

(2) Costs of conducting business in a new location or with a new class of customer (including costs of staff training);

(3) Costs of opening a new facility or business, such as, inauguration costs;

(4) Purchase price, including import duties and non–refundable purchase taxes, after deducting trade discounts and rebates.

With reference to AS 10 "Property, Plant and Equipment", classify the items under the following heads:

(i) Purchase Price of PPE

(ii) Directly attributable cost of PPE or

(iii) Cost not included in determining the carrying amount of an item of PPE.

Solution

(1) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment) will be classified as "Directly attributable cost of PPE".

(2) Costs of conducting business in a new location or with a new class of customer (including costs of staff training) will be classified under head (iii) as it will not be included in determining the carrying amount of an item of PPE.

(3) Costs of opening a new facility or business, such as, inauguration costs will be classified under head (iii) as it will not be included in determining the carrying amount of an item of PPE.

(4) Purchase price, including import duties and non–refundable purchase taxes, after deducting trade discounts and rebates will be included in determination of Purchase Price of PPE.

Question 5

In the year 2019-20, an entity has acquired a new freehold building with a useful life of 25 years for Rs. 45,00,000. The entity desires to calculate the depreciation charge per annum using a straight line method. It has identified the following components (with no residual value of lifts & fixtures at the end of their useful life) as follows:

Component	Useful life (Years)	Cost
Land	Infinite	10,00,000
Roof	25	5,00,000
Lifts	10	2,50,000
Fixtures	5	2,50,000
Remainder of building	25	25,00,000
		45,00,000

(i) Calculate depreciation for the year 2019-20 as per componentization method.
(ii) Also state the treatment, in case Roof requires replacement at the end of its useful life.

Solution

(i) Statement showing amount of depreciation as per Componentization Method

Component	Depreciation = Cost / Useful life	Depreciation (p.a.)
Land	-	Nil
Roof	5,00,000/25	20,000
Lifts	2,50,000/10	25,000
Fixtures	2,50,000/5	50,000
Remainder of building	25,00,000/25	1,00,000
		1,95,000

(ii) When the roof requires replacement at the end of its useful life, the carrying amount will be Nil. The cost of replacing the roof should be recognised as a new component.

Question 6

B Ltd. owns an asset with an original cost of Rs. 2,00,000. On acquisition, management determined that the useful life was 10 years and the residual value would be Rs. 20,000. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value. At the end of year 8, management has reviewed the useful life and residual value and has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by the company. As a result, the residual value will reduce to Rs. 10,000. How would the above changes in estimates be made by B Ltd.?

Solution

The above changes in estimates would be effected in the following manner:
The asset has a carrying amount of Rs. 56,000 at the end of year 8 [Rs. 2,00,000 – Rs. 1,44,000] i.e. Accumulated Depreciation.

Accumulated depreciation is calculated as

Depreciable amount {Cost less residual value} = Rs. 2,00,000 – Rs. 20,000 = Rs. 1,80,000.
Annual depreciation = Depreciable amount / Useful life = 1,80,000 / 10 = Rs. 18,000.
Accumulated depreciation = 18,000 × No. of years (8) = Rs. 1,44,000.
Revision of the useful life to 12 years results in a remaining useful life of 4 years (12 – 8).
The revised depreciable amount is Rs. 46,000. (56,000 – 10,000)
Thus, depreciation should be charged in future at Rs. 11,500 per annum (Rs. 46,000/4 years).

Question 7 Inter Nov 2020 (5 Marks)

A Ltd. had following assets. Calculate depreciation for the year ended 31st March, 2022 for each asset as per AS 10 (Revised):

a) Machinery purchased for ₹ 10 lakhs on 1st April, 2017 and residual value after useful life of 5 years, based on 2017 prices is ₹ 10 lakhs.

b) Land for ₹ 50 lakhs.

c) A Machinery is constructed for ₹ 5,00,000 for its own use (useful life is 10 years). Construction is completed on 1st April, 2021, but the company does not begin using the machine until 31st March, 2022.

d) Machinery purchased on 1st April, 2019 for ₹ 50,000 with useful life of 5 years and residual value is Nil. On 1st April, 2021, management decided to use this asset for further 2 years only.

Solution

Computation of Amount of Depreciation as per AS 10

		Amount
(i)	Machinery purchased on 1/4/17 for ₹ 10 lakhs (having residual value of ₹ 10 lakhs) **Reason:** The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost. Therefore, there is no depreciable amount and depreciation is correctly zero.	Nil
(ii)	Land (50 lakhs) (considered freehold) **Reason:** Land has an unlimited useful life and therefore, it is not depreciated.	Nil
(iii)	Machinery constructed for own use (₹5,00,000/10) **Reason:** The entity should begin charging depreciation from the date the machine is ready for use i.e. 1st April, 2021. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.	50,000
(iv)	Machinery having revised useful life **Reason:** The entity has charged depreciation using the straight-line method at ₹ 10,000 per annum i.e (50,000/5 years). On 1st April, 2021 the asset's net book value is [50,000 – (10,000 x 2)] i.e. ₹ 30,000. The remaining useful life is 2 years as per revised estimate. The company should amend the annual provision for depreciation to charge the unamortized cost over the revised remaining life of 2 years. Consequently, it should charge depreciation for the next 2 years at ₹ 15,000 per annum i.e. (30,000 / 2 years).	15,000

Question 8

RS Ltd. has acquired a heavy plant at a cost of ₹ 2,00,00,000. The estimated useful life is 10 years. At the end of the 2nd year, one of the major components i.e. the Boiler has become obsolete (which was acquired at price of ₹ 50,00,000) and requires replacement, as further maintenance is uneconomical. The remainder of the plant is perfect and is expected to last for next 8 years. The cost of a new boiler is ₹ 60,00,000.

Can the cost of the new boiler be recognised as an asset, and, if so, what should be the carrying value of the plant at the end of second year?

Solution:

Recognition of Asset: The new boiler will produce economic benefits to RS Ltd., and the cost is measurable. Hence, the item should be recognized as an asset. The cost old boiler should be de-recognized and the new boiler will be added.

Statement showing cost of new boiler and machine after year 2

Particular	₹
Original cost of plant	₹ 2,00,00,000
Less: Accumulated depreciation [(2,00,00,000 /10) x 2]	₹ 40,00,000
Carrying value of the plant after two years	₹ 1,60,00,000
Less: Current Cost of Old Boiler to be derecognized	
WDV of Boiler (replaced) after 2 years (50,00,000/10 x 8)	40,00,000
	1,20,00,000
Add: Cost of new Boiler to be recognized	60,00,000
Revised carrying amount of Plant	1,80,00,000

AS-11: THE EFFECT OF CHANGES IN FOREIGN EXCHANGE RATES

<table>
<tr><td>Scope</td><td colspan="2">AS-11 should be applied in
❖ Accounting for transactions in foreign currencies
❖ Translating the financial statements of foreign operations.
❖ Accounting for foreign currency transactions in the nature of forward exchange contracts</td></tr>
<tr><td colspan="3">FOREIGN CURRENCY TRANSACTIONS</td></tr>
<tr><td>Meaning</td><td colspan="2">It is a transaction which is denominated or requires settlement in a foreign currency.</td></tr>
<tr><td>Examples</td><td colspan="2">➢ Buying and selling of goods or services in foreign currency
➢ Lending or borrowing in foreign currency.
➢ Acquisition and disposition of asset denominated in foreign currency.</td></tr>
<tr><td>Initial recognition</td><td colspan="2">→ All transactions should be recorded at spot rate i.e. rate of foreign exchange at the date of transaction.
→ If spot rate is not given then average rate of a week or month can be used.</td></tr>
<tr><td rowspan="2">Subsequent recognition /reporting at subsequent balance sheet dates:</td><td>Monetary Item</td><td>These are the items which are receivable or payable in fixed or determinable amounts of money.
Example: Cash, debtors, creditors, etc
Use exchange rate at the balance sheet date</td></tr>
<tr><td>Non-monetary item</td><td>These all assets and liabilities other than monetary items.
Example: Fixed assets, inventories and investments in equity shares.
Use exchange rate at the date of transaction.
If item carried at fair value then use the exchange rate that existed when the values were determined</td></tr>
<tr><td rowspan="2">Recognition of exchange differences</td><td>Monetary Item</td><td>To be recognized as expenses or income i.e. to be debited or credited to P & L A/c</td></tr>
<tr><td>Non-monetary item</td><td>No subsequent recognition is required, there does not arise any exchange difference.</td></tr>
<tr><td colspan="3">SPECIAL CASE (MONETARY ITEMS) PARA 46 AND 46A (FOR COMPANY ONLY)</td></tr>
<tr><td>Applicability</td><td colspan="2">Exchange differences arising or reporting of long-term foreign currency monetary items. (LTFCMI)
Application of this Para is optional but once exercised it is irrevocable & applies to all such foreign currency monetary items.</td></tr>
<tr><td>Meaning of LTFCMI</td><td colspan="2">An asset or liability should be designated as long term foreign currency monetary item if –
➢ Asset or liability is expressed in a foreign currency and
➢ Has a term of 12 months or more at the date of origination of the asset or liability.</td></tr>
<tr><td>Exchange difference on LTFCMI</td><td>Related to depreciable capital assets</td><td>Add to/deduct from cost of asset and depreciate over the balance life of the asset</td></tr>
</table>

	Others	Accumulate in FCMITDA and amortize over the balance period of such long term item FCMITDA: Foreign Currency Monetary Item Translation Difference Account *Disclosed under Reserve & Surplus as separate line item*
Disclosure requirements	• Fact of such option • Amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized.	

FORWARD EXCHANGE CONTRACTS

Meaning	It means an agreement to exchange different currencies at a forward rate. Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.	
Categories	**For Trading or speculation purposes**	Gain or loss recognized in the Statement of P&L for the period. The premium or discount on the forward exchange contract is not recognised separately. At each balance sheet date the value of contract is marked to its current market value and the gain or loss on the contract is recognised.
	Not for Trading or speculation purposes	Premium or discount – amortize as expense or income over the life of contract.

The Effects of Changes in Foreign Exchange Rates (AS-11)

- Foreign Currency Transaction
  - Initial Recognition (Exchange Rate)
    - Spot Rate i.e. Rate of Transaction
  - Subsequent Recognition (Exchange Rate)
    - Monetary Items
      - B/S Date
    - Non Monetary Items
      - At Historical cost
        - Date of Transaction
      - At Fair Value
        - Date of Valuation
- Foreign Operations
- Forward Exchange Contracts
  - Trading or Speculation
    - Gain/Loss : P&L A/c
  - Not for Trading or Speculation
    - Premium or Discount amortize over life of contract

[Exchange Difference to be transferred to P&L A/c]

PARA 46A : Special Case

- Company Only : Optional
  - Long Term Foreign Currency Monetary Item (> 12 Months)
    - Exchange Difference
      - Related to Depreciable Capital Assets
        - Adjust cost of Asset (+, -)
      - Others
        - Accumulate in FCMITDA & amortize over period

Question 1

Sunshine Company Limited imported raw materials worth US Dollars 9,000 on 25th February, 2019, when the exchange rate was Rs. 64 per US Dollar. The transaction was recorded in the books at the above mentioned rate. The payment for the transaction was made on 10th April, 2019, when the exchange rate was Rs. 68 per US Dollar. At the year end 31st March, 2019, the rate of exchange was Rs. 69 per US Dollar.

The Chief Accountant of the company passed an entry on 31st March, 2019 adjusting the cost of raw material consumed for the difference between Rs. 68 and Rs. 64 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11 (Revised).

Solution

25/2 Purchase A/c - Dr 576000
To Creditors A/c 576000
(9000 X 64)

31/3 Exchange Diff. A/c - Dr 45000
To Creditors A/c 45000
(9000 x 5)

31/3 P&L A/c - Dr 45000
To Exchange Diff. A/c 45000

10/4 Creditors A/c - Dr 621000
(9000 X 68) To Bank A/c 612000
(9000 X 1) To Exchange Diff A/c 9000

Exchange Diff. A/c - Dr 9000
To P&L A/c 9000

As per AS 11, initial recognition of a foreign currency transaction is done in the reporting currency by applying the exchange rate at the date of the transaction. Accordingly, on 25th February 2019, the raw material purchased and its creditors will be recorded at US dollar 9,000 × Rs. 64 = Rs. 5,76,000.

Also, as per standard, on balance sheet date such transaction is reported at closing rate of exchange, hence it will be valued at the closing rate i.e. Rs. 69 per US dollar (USD 9,000 x Rs. 69 = Rs. 6,21,000) at 31st March, 2019, irrespective of the payment made for the same subsequently at lower rate in the next financial year.

The difference of Rs. 5 (69 – 64) per US dollar i.e. Rs. 45,000 (USD 9,000 x Rs. 5) will be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2019 and will not be adjusted against the cost of raw materials.

In the subsequent year on settlement date, the company would recognize or provide in the Profit and Loss account an exchange gain of Rs. 1 per US dollar, i.e. the difference from balance sheet date to the date of settlement between Rs. 69 and Rs. 68 per US dollar i.e. Rs. 9,000.

Hence, the accounting treatment adopted by the Chief Accountant of the company is incorrect i.e. it is not in accordance with the provisions of AS 11

Question 2 Inter May 2018 (5 Marks)

ABC Ltd. borrowed US $ 5,00,000 on 01/01/2019, which was repaid as on 31/07/2019. ABC Ltd. prepares financial statement ending on 31/03/2019. Rate of Exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/2019	1 US$ =	68.50
31/03/2019	1 US$ =	69.50
31/07/2019	1 US$ =	70.00

You are required to pass necessary journal entries in the books of ABC Ltd. as per AS 11.

Solution

Date	**Particulars**	**Dr.**	**Cr.**
Jan. 01, 2019	Bank A/c (5,00,000*68.50) Dr.	3,42,50,000	
	To Foreign Loan A/c		3,42,50,000
Mar. 31, 2019	Foreign Exchange Difference A/c Dr.	5,00,000	
	To Foreign Loan A/c		5,00,000
	[5,00,000*(69.50-68.50)]		
Mar. 31, 2019	Profit & Loss A/c Dr.	5,00,000	
	To Foreign Exchange Difference A/c		5,00,000
Jul. 31, 2019	Foreign Loan A/c Dr.	3,47,50,000	
	Foreign Exchange Difference A/c Dr.	2,50,000	
	To Bank A/c		3,50,00,000
	Profit & Loss A/c Dr.	2,50,000	
	To Foreign Exchange Difference A/c		2,50,000

Question 3 Inter Nov 2018 (5 Marks)

(i) ABC Ltd. a Indian Company obtained long term loan from WWW private Ltd., a U.S. company amounting to Rs. 30,00,000. It was recorded at US $1 = Rs. 60.00, taking exchange rate prevailing at the date of transaction. The exchange rate on balance sheet date (31.03.2020) was US $1 = Rs. 62.00.

(ii) Trade receivable includes amount receivable from Preksha Ltd., Rs. 10,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = Rs. 59.00. The exchange rate on balance sheet date (31.03.2020) was US $1 = Rs. 62.00.

You are required to calculate the amount of exchange difference and also explain the accounting treatment needed in the above two cases as per AS 11 in the books of ABC Ltd.

Solution

Amount of Exchange difference and its Accounting Treatment

	Long term Loan	**Foreign Currency Rate**	**Rs.**
(i)	Initial recognition US $ 50,000 Rs. (30,00,000/60)	1 US $ = Rs. 60	30,00,000
	Rate on Balance sheet date	1 US $ = Rs. 62	
	Exchange Difference Loss US $ 50,000 x Rs. (62 – 60)		1,00,000
	Treatment: Credit Loan A/c and Debit FCMITD A/c or Profit and Loss A/c by Rs. 1,00,000		
	Trade receivables		
(ii)	Initial recognition US $ 16,949.152* (Rs.10,00,000/59)	1 US $ = Rs. 59	10,00,000
	Rate on Balance sheet date	1 US $ = Rs. 62	
	Exchange Difference Gain US $ 16,949.152* x Rs. (62-59)		50,847.456*
	Treatment: Credit Profit and Loss A/c by Rs. 50,847.456*		
	and Debit Trade Receivables		

Thus, Exchange Difference on Long term loan amounting Rs. 1,00,000 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on trade receivables amounting Rs. 50,847.456 is required to be transferred to Profit and Loss A/c.

Question 4

Legal Ltd. is engaged in the manufacturing of rubber. For its plant, it required machineries of latest technology. It usually resorts to Long Term Foreign Currency Borrowings for its fund requirements. On 1st April, 2021, it borrowed US $1 million from International Funding Agency, USA when exchange rate was 1 $ = ₹ 63. The funds were used for acquiring machineries, on the same date, to be used in three different plants. The useful life of the machineries is 10 years and their residual value is ₹ 30,00,000.

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

Now for this new purchase of machinery, Legal Ltd, is interested to avail the option of capitalizing the same to the cost of asset. Exchange rate on 31st March, 2022 is 1 US $ = ₹ 62. Assume that on 31st March, 2022, Legal Ltd. is not having any old long term foreign currency borrowings except for the amount borrowed for machinery purchased on 1st April, 2021.

Comment whether Legal Ltd. can capitalize the exchange difference to the cost of asset on 31st March, 2022. If yes, then calculate the depreciation amount on machineries as on 31st March, 2022.

Solution

As per paragraph 46A of AS 11, 'The Effects of Changes in Foreign Exchange Rates', in respect of accounting periods commencing on or after 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 or not (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, though Legal Ltd. had not earlier exercised the option, yet it can avail the option to capitalize the exchange difference to the cost of machinery by virtue of para 46A of AS 11. Further, since Legal Ltd. has no earlier long term foreign currency borrowings, it is not required to apply capitalization option to earlier borrowing also.

Exchange difference to be capitalized and depreciation amount

Cost of the asset in $	1 million
Exchange rate on 1st April, 2021	1$ = ₹ 63
Cost of the asset in ₹ (1 million x ₹ 63)	63 million
Less: Exchange differences as on 31st March, 2022 (63-62) x $ 1 million (Gain)	(1 million)
	62 million
Less: Depreciation for 2021-22 (62 million - 3 million) /10 years	(5.90 million)
	56.10 million

Question 5

Rahul Ltd. purchased a plant for US$ 2,00,000 on 1st January 2019, payable after 5 months. Company entered into a forward contract for five months @ Rs. 64.75 per dollar. Exchange rate per dollar on 1st Jan. 2019 was Rs. 64.25. How will you recognize the profit or loss on forward contract in the books of Rahul Ltd.?

Solution

Calculation of profit or loss to be recognized in the books of Rahul Limited

	Rs.
Forward contract rate	64.75
Less: Spot rate	(64.25)
Loss/Premium on Contract	0.50
Forward Contract Amount	$2,00,000
Total loss on entering into forward contract = ($2,00,000 × Rs. 0.50)	Rs. 1,00,000
Contract period	5 months
Loss for the period 1st January, 2019 to 31st March, 2019 i.e. 3 months falling in the year 2018-2019 will be Rs. 1,00,000*3/5 =	Rs. 60,000

Balance loss of Rs. 40,000 (i.e. Rs. 1,00,000 – Rs. 60,000) for the month of April, 2019 & May 2019 will be recognized in the financial year 2019-2020.

Question 6

Mr. Y bought a forward contract for three months of US $ 2,00,000 on 1st December 2019 at 1 US $ = Rs. 44.10 when the exchange rate was 1 US $ = Rs. 43.90. On 31-12-2019, when he closed his books, exchange rate was 1 US $ = Rs. 44.20. On 31st January, 2020 he decided to sell the contract at Rs. 44.30 per Dollar. Show how the profits from the contract will be recognized in the books of Mr. Y.

Solution

As per AS 11, in recording a forward exchange contract intended for trading or speculation purpose, the premium or discount on the contract is ignored and at each balance sheet date, the value of contract is marked to its current market value and the gain or loss on the contract is recognised. Since the forward contract was for speculation purposes the premium on forward contract i.e. the difference between the spot rate and the forward contract rate will not be recorded in the books.

Only when the forward contract is sold the difference between the forward contract rate and sale rate will be recorded in the Profit & Loss Account.

	Rs.
Sale rate	44.30
Less: Contract rate	(44.10)
Profit on sale of contract per US$	00.20

Contract Amount US $ 2,00,000

Total profit (2,00,000 x 0.20) Rs. 40,000

AS-12:
ACCOUNTING FOR GOVERNMENT GRANTS

Meaning of Government	Refers to government, government agencies and similar bodies whether local, national or international.
Meaning of Government Grants	Assistance by Government in cash/kind to an enterprise for past or future compliance with certain conditions
Other nomenclatures	Subsidies, Cash incentives, etc.
Recognition of Government grant	When there is a reasonable assurance that ➢ The enterprise will comply with the conditions attached to them and ➢ The grants will be received

Question 1

X Ltd. purchased machinery for Rs. 80 lakhs. (useful life 4 years and residual value Rs. 8 lakhs). Government grant received is Rs. 32 lakhs.

Pass the Journal Entries for the first 2 years if

(i) the grant is credited to Fixed Assets A/c.

(ii) the grant is credited to Deferred Grant A/c

Solution

(i) Grant is credited to Fixed Assets A/c

Year	Particulars	L.F.	Dr. (in Lakhs)	Cr. (in Lakhs)
1	Machinery Account Dr.		80	
	To Bank Account			80
	(Being fixed asset purchased)			
	Bank Account Dr.		32	
	To Machinery Account			32
	(Being grant received from the government reduced the cost of fixed asset)			
	Depreciation Account Dr. [(80-32)-8]/4		10	
	To Machinery Account			10
	(Being depreciation charged on Straight Line method (SLM))			
	Profit & Loss Account Dr.		10	
	To Depreciation Account			10
	(Being depreciation transferred to Profit and Loss Account at the end of year 1)			
2	Depreciation Account Dr.		10	
	To Machinery Account			10
	(Being depreciation charged on Straight Line method (SLM))			
	Profit & Loss Account Dr.		10	
	To Depreciation Account			10
	(Being depreciation transferred to Profit and Loss Account at the end of year 2)			

(ii) Grant is credited to Deferred Grant A/c

Year	Particulars	L.F.	Dr. (in Lakhs)	Cr. (in Lakhs)
1	Machinery Account Dr.		80	
	To Bank Account			80
	(Being fixed asset purchased)			
	Bank A/c Dr.		32	
	To Deferred Government Grant A/c			32
	(Being grant received from the government treated as deferred income)			
	Depreciation A/c Dr. (80-8)/4		18	
	To Machinery A/c			18
	(Being depreciation charged on Straight Line method (SLM))			
	Profit & Loss A/c Dr.		18	
	To Depreciation A/c			18
	(Being depreciation transferred to Profit and Loss Account at the end of year 1)			
	Deferred Government Grant A/c Dr. (32/4)		8	

	To Profit & Loss A/c			8
	(Being proportionate government grant taken to P/L A/c)			
2	Depreciation A/c Dr.		18	
	To Machinery A/c			18
	(Being depreciation charged on Straight Line method (SLM))			
	Profit & Loss A/c Dr.		18	
	To Depreciation A/c			18
	(Being depreciation transferred to Profit and Loss Account at the end of year 2)			
	Deferred Government Grant A/c Dr.		8	
	To Profit & Loss A/c			8
	(Being proportionate government grant taken to P/L A/c)			

Question 2

X Ltd. purchased machinery for Rs. 80 lakhs. (useful life 4 years and residual value Rs. 8 lakhs). Government grant received is Rs. 32 lakhs.

Show the Journal Entry to be passed at the time of refund of grant at the beginning of year 3 and the value of the fixed assets in the third year and the amount of depreciation for remaining two years, if

(i) the grant is credited to Fixed Assets A/c.

(ii) the grant is credited to Deferred Grant A/c

Solution

(i) Grant is credited to Fixed Assets A/c

a) Journal Entry (at the time of refund of grant)

Particulars	L.F.	Dr. (in Lakhs)	Cr. (in Lakhs)
Machinery Account Dr.		32	
To Bank Account			32
(Being government grant refunded)			

b) Value of Fixed Assets after two years but before refund of grant

Fixed assets initially recorded in the books = Rs. 80 lakhs – Rs. 32 lakhs = Rs. 48 lakhs

Depreciation for each year = (Rs. 48 lakhs – Rs.8 lakhs)/4 years

= Rs. 10 lakhs per year for first two years.

Value of the assets before refund of grant =Rs. 48 lakhs - Rs. 20 lakhs = Rs. 28 lakhs

c) Value of Fixed Assets after refund of grant

Value of Fixed Assets before refund of grant	Rs. 28 lakhs
Add Refund of grant	Rs. 32 lakhs
	Rs. 60 lakhs

d) Amount of depreciation for remaining two years

Value of the fixed assets after refund of grant –residual value of the assets / No. of years

= Rs. 60 lakhs - Rs. 8 lakhs / 2

= Rs. 26 lakhs per annum will be charged for next two years.

(ii) Grant is credited to Deffered Grant A/c

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

Accordingly, in the first two years (Rs. 32 lakhs /4 years) = Rs. 8 lakhs x 2 years = Rs. 16 lakhs will be credited to Profit and Loss Account and Rs. 16 lakhs will be the balance of Deferred Grant Account after two years.

a) Journal Entry (at the time of refund of grant)

Particulars	**L.F.**	**Dr. (in Lakhs)**	**Cr. (in Lakhs)**
Deffered Govt. Grant A/c Dr.		16	
P&L A/c Dr.		16	
To Bank Account			32
(Being government grant refunded)			

b) Value of Fixed Assets after two years but before refund of grant
Fixed assets initially recorded in the books = Rs. 80 lakhs
Depreciation for each year = (Rs. 80 lakhs – Rs.8 lakhs)/4 years = Rs. 18 lakhs per year
Book value of fixed assets after two years = Rs. 80 lakhs – (Rs. 18 lakhs x 2 years) = Rs. 44 lakhs

c) Value of Fixed Assets after refund of grant
On refund of grant the balance of deferred grant account will become nil. The fixed assets will continue to be shown in the books at Rs. 44 lakhs.

d) Amount of depreciation for remaining two years
Depreciation will continue to be charged at Rs. 18 lakhs per annum for the remaining two years

Question 3

On 01.04.2016, XYZ Ltd. received Government grant of Rs. 100 Lakhs for an acquisition of new machinery costing Rs. 500 lakhs. The grant was received and credited to the cost of the assets. The life span of the machinery is 5 years. The machinery is depreciated at 20% on WDV method. The company had to refund the entire grant in 2nd April, 2019 due to non-fulfilment of certain conditions which was imposed by the government at the time of approval of grant. How do you deal with the refund of grant to the Government in the books of XYZ Ltd., as per AS 12?

Solution

According to AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset (if the grant had been credited to the cost of fixed asset at the time of receipt of grant) should be recorded by increasing the book value of the asset, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(in Lakhs)
1st April 2016	Acquisition cost of machinery (500 – 100)	400.00
31st March 2017	Less: Depreciation @ 20%	(80.00)
1st April 2017	Book value	320.00
31st March 2018	Less: Depreciation @ 20%	(64.00)
1st April 2018	Book value	256.00
31st March 2019	Less: Depreciation @ 20%	(51.20)
1st April 2019	Book value	204.80
2nd April 2019	Add: Refund of grant	100.00
	Revised Book value	**304.80**

Depreciation @ 20% on the revised book value amounting Rs. 304.80 lakhs is to be provided prospectively over the residual useful life of the asset.

Question 4

S Ltd. received a grant of Rs. 5,000 lakhs during the last accounting year (2018-19) from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for

its utilization. However, during the year 2019-20, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full.
Elucidate the correct accounting treatment, with reference to the provisions of AS 12.

Solution

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

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

In the present case, the amount of refund of government grant should be shown in the profit and loss account of the company as an extraordinary item during the year 2019-20.

Question 5

Samrat Limited has set up its business in a designated backward area which entitles the company for subsidy of 25% of the total investment from Government of India. The company has invested Rs. 80 crores in the eligible investments. The company is eligible for the subsidy and has received Rs. 20 crores from the government in February 2020. The company wants to recognize the said subsidy as its income to improve the bottom line of the company.

Do you approve the action of the company in accordance with the Accounting Standard?

Also state whether the company can distribute this amount by way of dividend

Solution

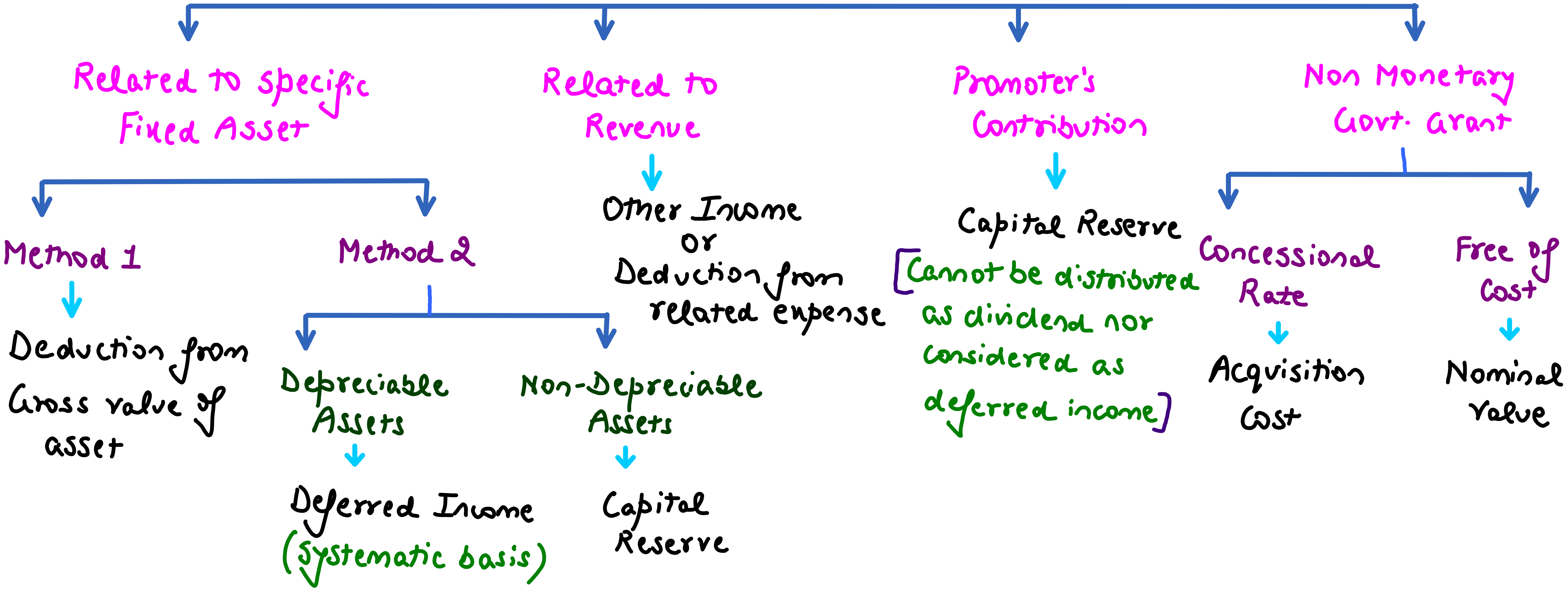
As per AS 12 "Accounting for Government Grants", where the government grants are in the nature of promoters' contribution, *i.e.,* they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, Central Investment Subsidy Scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

The subsidy received by Samrat Ltd. for setting up its business in a designated backward area will be treated as grant by the government in the nature of promoter's contribution as the grant is given with reference to the total investment in an undertaking i.e. subsidy is 25% of the eligible investment and also no repayment is apparently expected in respect thereof.

Since the subsidy received is neither in relation to specific fixed assets nor in relation to revenue. Thus, the company cannot recognize the said subsidy as income in its financial statements in the given case. It should be recognized as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Accounting for Government Grant (AS-12)

[Assistance by Government in cash / kind to enterprise for compliance with certain conditions]



- Related to specific Fixed Asset
  - Method 1
    - Deduction from Gross value of asset
  - Method 2
    - Depreciable Assets
      - Deferred Income (Systematic basis)
    - Non-Depreciable Assets
      - Capital Reserve
- Related to Revenue
  - Other Income or Deduction from related expense
- Promoter's Contribution
  - Capital Reserve [Cannot be distributed as dividend nor considered as deferred income]
- Non Monetary Govt. Grant
  - Concessional Rate
    - Acquisition Cost
  - Free of Cost
    - Nominal Value

Refund of Grant

[To be treated as Extraordinary Item as per AS-5]

- Related to Specific Fixed Asset
  - If Method 1
    - Increase Book value of Asset
    - Provide Depreciation on Revised Book value prospectively
  - If Method 2
    - Depreciable Assets
      - First utilize unamortize deferred credit. Excess tfd. to P&L A/c
    - Non-Depreciable Assets
      - Reduce Capital Reserve
- Related to Revenue
  - First utilize unamortize deferred credit. Excess tfd. to P&L A/c
- Promoter's Contribution
  - Reduce Capital Reserve