1 Applicability of Accounting Standards

1. Status of Accounting Standards in India

Accounting Standards are developed by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India and are issued under the authority of its Council. The institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. If an accounting standard is mandatory then its mandatory status will apply as under:

A. Mandatory by the provisions of the law applicable to the entity:

If the entity is required to apply the accounting standards by the provisions of law regulating such entity then it will be compulsory for the entity to follow those accounting standards. **Section 129 (1) of the Companies Act, 2013 requires companies to present their financial statements in accordance with the accounting standards notified under Section 133 of the Companies Act, 2013. Also, the auditor is required by section 143(3)(e) to report whether, in his opinion, the financial statements of the company audited, comply with the accounting standards referred to in section133 of the Companies Act, 2013.** Where the financial statements of a company do not comply with the accounting standards, the company should disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviations as per Section 129(5) of the Companies Act, 2013. Provided also that the financial statements should not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose:

a. In the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999.

b. In the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

c. In the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

d. In the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Note: As per the Companies Act, 2013, the Central Government may prescribe standards of accounting or addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with NACAS/NFRA. Till date, the Central Government has notified all the existing accounting standards

B. When Accounting Standards are not mandatory for the entity by any law applicable to it:

Where the statute governing the enterprise does not require compliance with the accounting standards, e.g. a partnership firm, the mandatory status of an accounting standard implies that, in discharging their attest functions, the Chartered Accountants are required to examine whether the financial statements are prepared in compliance with the applicable accounting standards. In the event of any deviation from the accounting standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

2. Income Computation and Disclosure Standards Under Income Tax Act 1961:

Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assessees or in respect of any class of income. Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by **all assessees** (other than an individual or a Hindu undivided family who is not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB) following the **mercantile system of accounting**, for the purposes of computation of income chargeable to income-tax under the head **"Profit and gains of business or profession" or " Income from other sources",** from A.Y. 2017-18. The ten notified ICDSs are:

a. ICDS I : Accounting Policies

b. ICDS II : Valuation of Inventories

c. ICDS III : Construction Contracts

d. ICDS IV : Revenue Recognition ICDS

e. ICDS V : Tangible Fixed Assets.

f. ICDS VI : The Effects of Changes in Foreign Exchange Rates

g. ICDS VII : Government Grants

h. ICDS VIII : Securities

i. ICDS IX : Borrowing Costs

j. ICDS X : Provisions, Contingent Liabilities and Contingent Assets

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

A. Level I Entities

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

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose **turnover** (excluding other income) **exceeds rupees fifty crore** in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having **borrowings** (including public deposits) in excess of rupees **ten crore** at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

B. Level II Entities (SMEs)

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

(i) All commercial, industrial and business reporting entities, whose **turnover** (excluding other income) **exceeds rupees one crore** but does **not exceed rupees fifty crore** in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having **borrowings** (including public deposits) in **excess of rupees one crore but not in excess of rupees ten crore** at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

C. Level III Entities (SMEs)

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

Additional requirements:

(a) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(b) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(c) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(d) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which

it has availed the exemption or relaxation.

(e) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(f) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard, provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

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

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

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

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

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

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

B. Non-SMCs

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

General Instructions:

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

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

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

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

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

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

    e. The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard, provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

f. Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below: An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, should not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods.

PRACTICE PROBLEM:

Question 1

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

Solution

a. The question deals with the issue of Applicability of Accounting Standards to a non-corporate entity. For availing the exemptions, first of all, it has to be seen that M/s Omega & Co. falls in which level of the non-corporate entities.

b. Its classification will be done on the basis of the classification of non-corporate entities as prescribed by the ICAI. According to the ICAI, non-corporate entities can be classified under 3 levels viz Level I, Level II (SMEs) and Level III (SMEs).

c. An entity whose turnover was more than 50 crore in the previous accounting year or borrowing was more than 10 crore at any time during the previous accounting year is classified in Level I but as we can see that M/s Omega & Co is not satisfying any of the following conditions, therefore it can't be classified as Level I entity.

d. An entity whose turnover was more than 1 crore but not more than 50 crore in the previous accounting year or its borrowing has been more than 1 crore but not more than 10 crore at any time during the previous accounting year will be classified as Level II entity.

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

Question 2

"Accounting Standards standardize diverse accounting policies with a view to eliminate the non-comparability of financial statements and improve the reliability of financial statements. "Discuss and explain the benefits of Accounting Standards.

Answer:

Accounting Standards standardize diverse accounting policies with a view to eliminate the non-comparability of financial statements and improve the reliability of financial statements. Accounting Standards provide a set of standard accounting policies, valuation norms and disclosure requirements. Accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements.

The following are the benefits of Accounting Standards:

a. Standardization of alternative accounting treatments:

   Accounting Standards reduce to a reasonable extent confusing variations in the accounting treatment followed for the purpose of preparation of financial statements.

b. Requirements for additional disclosures:

   There are certain areas where important is not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

c. Comparability of financial statements:

   The application of accounting standards would facilitate comparison of financial statements of different companies situated in India and facilitate comparison, to a limited extent, of financial statements of companies situated in different parts of the world. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in Accounting Standards adopted in different countries.

2 AS 1 Disclosure of Accounting Policies

1. **This accounting standard is mandatory for all the entitites.**

2. **Nature of Accounting Policies:**

   a. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.(Para 11)

   b. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise.(Para 12).

3. **Areas in Which Differing Accounting Policies Are Encountered**

   The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

   (a) Methods of depreciation, depletion and amortisation

   (b) Treatment of expenditure during construction

   (c) Conversion or translation of foreign currency items

   (d) Valuation of inventories

   (e) Treatment of goodwill

   (f) Valuation of investments

   (g) Treatment of retirement benefits

   (h) Recognition of profit on long-term contracts

   (i) Valuation of fixed assets

   (j) Treatment of contingent liabilities.

4. **Disclosure of Accounting Policies**

   (a) To ensure proper understanding of financial statements, it is necessary that all

significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed (Para 18).

(b) Such disclosure should form part of the financial statement.(Para 19).

(c) It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes (Para 20).

(d) Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.(Para 22).

(e) Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts (Para 23).

5. Considerations in the Selection of Accounting Policies

(a) The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.

(b) For this purpose, the major considerations governing the selection and application of accounting policies are:

(i) Prudence

In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

(ii) Substance over Form

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

(iii) Materiality

Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

6. Fundamental Accounting Assumptions

A. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. **Disclosure is necessary if they are not followed (Para 9).**

B. The following have been generally accepted as fundamental accounting assumptions:

(i) Going Concern

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

(ii) Consistency

It is assumed that accounting policies are consistent from one period to another.

(iii) Accrual

Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this standard) **(Para10).**

PRACTICAL PROBLEMS

Question 1

In the books of M/s Prashant Ltd., closing inventory as on 31.03.2015 amounts to` 1,63,000 (on the basis of FIFO method). The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 2014-15. On the basis of weighted average method, closing inventory as on 31.03.2015 amounts to ` 1,47,000. Realisable value of the inventory as on 31.03.2015 amounts to ` 1,95,000.

Discuss disclosure requirement of change in accounting policy as per AS-1.

Solution

As per AS 1 "Disclosure of Accounting Policies", any change in an accounting policy which has a material effect should be disclosed in the financial statements. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. Thus Prashant Ltd. should disclose the change in valuation method of inventory and its effect on financial statements. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e. 2014-15, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by ` 16,000.

Question 2

ABC Ltd. was making provision for non-moving inventories based on issues for the last

12 months up to 31.3.2016. The company wants to provide during the year ending 31.3.2017 based on technical evaluation:

Total value of inventory	` 100 lakhs
Provision required based on 12 months issue	` 3.5 lakhs
Provision required based on technical evaluation	` 2.5 lakhs

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

Solution

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

In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ` 3.5 lakhs to ` 2.5 lakhs is also not material having regard to the value of inventory of `100 lakhs. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2016-17:

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

Question 3

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

a. Value year-end inventory at works cost (` 50 crores) instead of the hitherto method of valuation of inventory at prime cost (` 30 crores).
b. Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at ` 27 crores is lower than the amount of ` 45 crores which would have been provided had the old method been followed, by ` 18 cores.
c. Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now

decided to account for expenses as and when actually incurred. Sales during the year total to ` 600 crores.

d. Provide for permanent fall in the value of investments, which fall had taken place over the past five years - the provision being ` 10 crores.

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

Solution

1. As per AS 1, any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. Accordingly, the notes on accounts should properly disclose the change and its effect.
2. Notes on Accounts:
    a. During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost which was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ` 50 crores and the profit for the year is increased by ` 20 crores.
    b. In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at ` 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by ` 18 crores. To that extent, the profit for the year is increased.
    c. The company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for

the year is increased by ` 12 crores than would have been the case if the old policy were to continue.

d. The company has decided to provide ` 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ` 10 crores.

Question 4

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

Solution

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

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

of the overdue interest liability amounts to violation of accrual basis of accounting. Therefore, the treatment, done by the company, of not providing the interest amount from due date to the date of repayment is not correct.

Question 5

HIL Ltd. was making provision for non-moving stocks based on no issues having occurred for the last 12 months upto 31.03.2017. The company now wants to make provision based on technical evaluation during the year ending 31.03.2018.

Total value of stock ` 120 lakhs

Provision required based on technical evaluation ` 3.00 lakhs.

Provision required based on 12 months no issues ` 4.00 lakhs.

You are requested to discuss the following points in the light of Accounting Standard (AS)-1:

a. Does this amount to change in accounting policy?

b. Can the company change the method of accounting?

Answer

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

In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ` 4 lakhs to ` 3 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of HIL Ltd. for the year 2017 -18 in the following manner:

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

3 AS 2 VALUATION OF INVENTORIES

1. This accounting standard is mandatory for all the entities.

2. **Meaning:**

Inventories are assets:

i. Held for sale in the ordinary course of business;

ii. In the process of production for such sale; or

iii. In the form of materials or supplies to be consumed in the production process or in the rendering of services, including maintenance supplies and consumables other than machinery spares, servicing equipment and standby equipment meeting the definition of "Property, Plant and Equipment" as per AS 10 Revised.

3. **Exceptions for application:**

This Standard should be applied in accounting for inventories other than:

(a) work in progress arising under construction contracts, including directly related service contracts but excluding the inventories to be used in the construction work of the contracts such as sand, cement, steel etc.

(b) work in progress arising in the ordinary course of business of service providers but including the value of materials used in rendering of service by such service provider;

(c) shares, debentures and other financial instruments held as stock-in-trade; and

(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

4. **Measurement of Inventories**

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

5. **Cost of Inventories**

The cost of inventories should comprise all

a. Costs of purchase,

b. Costs of conversion and

c. Other costs incurred in bringing the inventories to their present location and condition.

6. Costs of Purchase

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase. Cash discount is a kind of interest saving therefore it is not deducted from the cost of purchase.

7. Costs of Conversion

The costs of conversion of inventories include costs directly related to production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

8. Allocation of Fixed Production Overheads and Variable Production Overheads:

The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Note 1 : Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.

Note 2: The actual level of production may be used if it approximates normal capacity.

Note 3 : The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant.

Note 4 : Unallocated overheads are recognised as an expense in the period in which they are incurred.

Note 5 : In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost.

Note 6 : Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

9. Treatment of Joint Product and By Products:

A production process may result in more than one product being produced simultaneously, all those products are called Joint Products and By Products. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may sale value at split off point or sale value after further processing. Most By Products as well as scrap or waste materials, by their nature, are immaterial. They are often measured at net realisable value and this value is deducted from the cost of the main product. As a result the Main Product is valued at total cost minus net realizable value of By Product.

10. Other Costs:

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

For example, it may be appropriate to include overheads other than production overheads such as the costs of designing products for specific customers in the cost of inventories.

11. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories. But as per the provisions of AS 16 Borrowing Cost, interest can be included in the cost of inventory such inventory takes substantial period of time before getting ready for sale.

12. AS 2 is completely silent about inclusion of Amortisation of Intnagible Assets in the cost of inventory. But it appears that it is necessary to include amortization of those intangible assets that are directly related to production of goods, such as patent related to production of goods or copy right related to printing of books or any license related to production or extraction of goods.

13. Exchange differences are not taken in inventory costs

14. Exclusions from Cost of Inventories:

a. Abnormal amounts of wasted materials, labour, or other production costs;

b. Storage costs, unless those cost are necessary in the production process prior to a further production stage;

c. Administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

d. Selling and distribution costs.

15. Cost Formulas:

A. Specific Identification Method:

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

B. FIFO and Weighted Average Method:

The cost of inventories should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

16. Techniques for the Measurement of Cost

Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost.

A. Standard Cost Method:

In this method cost of inventory is taken on the basis of standard cost per unit. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

B. Retail Price Method:

The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the

appropriate percentage gross margin.

17. Net Realisable Value:

A. Net Realisable Value means estimated selling price of the inventory as reduced by estimated cost to complete it and selling expenses.

B. Inventories are usually written down to net realisable value on an item- by-item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

C. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

D. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices.

E. 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 or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

F. An assessment is made of net realisable value as at each balance sheet date.

18. Disclosure Requirements:

The financial statements should disclose:

a. The accounting policies adopted in measuring inventories, including the cost formula used; and

b. The total carrying amount of inventories and its classification appropriate to the enterprise.

PRACTICAL PROBLEMS

Question: 1

X Ltd. manufacture computers, during the year ended 31st March, 2010 the company manufactured 550 computers, it has the policy of valuing finished stock of goods at a standard cost of Rs. 1.8 lakhs per computer. The details of the cost are as under :

	(Rs. In Lakhs)
Raw material consumed	400
Direct Labour	250
Variable production overheads	150
Fixed production overheads	290
(Including interest of Rs. 100)	

Computer the value of cost per computer for the purpose of closing stock.

Answer: ` 1.8 lakhs Per Computer.

Question: 2

Raw material was purchased at Rs. 100 per kg. Price of raw material is on the decline. The finished goods in which the raw material is incorporated are expected to be sold at below cost. 10,000 kgs. of raw material is in stock at the year-end. Replacement cost is Rs. 80 per kg. How will you value the inventory?

Answer: ` 8,00,000

Question: 3

In a production process, normal waste is 5% of input. 5000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is Rs. 1,000. The entire quantity of waste in on stock at the year end. If waste has Nil realisable value. What is the cost per unit?

Answer: Cost per unit is `1052.6315

Question: 4

How will you value the inventory per kg. of finished goods consisted of :

Material cost	Rs. 100 per kg.
Direct Labour cost	Rs. 20 per kg.
Direct variable production overhead	Rs. 10 per kg.

Fixed production charges for the year on normal capacity of one lakh kgs. is Rs. 10 lakhs. 2000 kgs. of finished goods are on stock at the year-end.

Answer: ` 2,80,000

Question: 5

The Company sells IMFL and beer to the customers, some of the customers consumed the beer in the bars run by it. While leaving the bar, the consumers left the empty bottles in the bars and the company takes the possession of these empty bottles. These empty bottles are disposed of by the company. The company has laid down detailed procedures for the maintenance of the records, tenders to be called for the disposal of empty bottles etc.

Keep in view the above :

(a) Whether the stock of empty bottles is an asset of the company.

(b) If so, whether the stock of empty bottles existing as on the date of the balance sheet is to be considered as inventories of the company.

(c) If the answer to (b) above is positive, then what should be the value at which it is to be shown in the financial statements of the company.

Answer:

(a) Asset means any resource which is controlled by the entity and expected to generate future economic benefit for the entity. Therefore, yes this is an asset for the company.

(b) Yes it is part of inventory because it is arising during the ordinary course of business and expected to generate future economic benefit for the entity.

(c) As company has not incurred any cost for these bottles, therefore these will be recorded in the financial statement at nominal value of `1.

Question: 6

A Ltd. produces chemical, X which has following production cost per unit :

Raw Material	= Rs. 5
Direct Labour	= Rs. 2
Direct Expenses	= Rs. 3
Normal capacity	= 5,000 units per annum
Actual production	= 4,000 units
Fixed Production Overhead	= Rs. 20,000 per annum

The company has 2,000 units of unsold stock lying with it at the end of year. You are required to value the closing stock. What would have been your answer is the actual production was 8000 units.

Answer: (a) ` 28,000 (b) `25,000

Question: 7

The Company incurred Rs. 20,00,000 as fixed production overhead per year. It normally produces 1,00,000 units in a year. In 2009-10 however its production has been only 40,000 units. At the year-end 31.03.2010 the closing stock was 10,000 units. The cost of unit is below:

Material	= Rs. 500 per unit
Labour	= Rs. 250 per unit
Fixed Production overhead	= Rs. 20,00,000 p.a.
Fixed administration	= Rs. 10,00,000 p.a.

Calculate the value of closing stock. What would have been your answer if actual production were 1,25,000 units.

Answer: (a) ` 77,00,000 (b) `76,60,000

Question: 8

The Company deals in three products X, Y and Z, which are neither similar nor interchangeable. At the time of closing of its account for the year 2001-2002. The historical cost and net realisable values of the items of closing stock are determined as below :

Items	Historical Cost (Rs. In lakhs)	Net realisable value (Rs. In lakhs)
X	20	14
Y	16	16
Z	8	12
	44	**42**

What will be the value of closing stock?

Answer: `28 Lakhs

Question: 9

XYZ Ltd. produced 10,00,000 units of product A during 2009-10 per unit cost is as follows :

Raw Material	Rs. 100
Direct Wages	Rs. 50
Direct Expenses	Rs. 2
	Rs. 152

Production overhead is Rs. 20,00,000 of which 40% is fixed. The company sold 8,00,000 units and 2,00,000 units were in stock as on 31st March, 2002. Normal capacity is 5,00,000 units.

Calculate the value of closing stock.

Answer: ` 3,08,00,000

Question: 10

Cost of Production of product X is given below :

Raw Material per unit	Rs. 120
Wages per unit	Rs. 80
Overhead per unit	Rs. 50
	Rs. 250

As on the balance sheet date the replacement cost of raw material is Rs. 110 per unit. There were 1000 units of raw material on 31.03.2002.

Calculate the value of closing stock of raw material in following conditions :

(a) If finished product is sold at the rate of Rs. 275 per unit, what will be value of closing stock of raw material.

(b) If finished product is sold at the rate of Rs. 230 per unit, what will be value of closing stock of raw material.

Answer:

(a) 1,20,000 (b) 1,10,000

Question: 11

A Company produced the main products X and Y and one by-product Z emerges from the production process apart from waste. Cost description of the production process is hereunder:

Item	Unit	Rs.	Output	Closing stock as on 31.03.2002
Raw Material	10,000	1,00,000	X = 4000 unit	500

Wages	50,000	Y = 3000 unit	100
Fixed overhead	50,000	Z = 1000 unit	---
Variable overhead	30,000		---

Scrap realization is Rs. 2,000. By-product (Z) is sold @ 20 per unit. There is separate processing charge of Rs. 2,000, packing on by product cost Rs. 3,000 reasonable profit on by-product after separate processing is Rs. 2000. Average market price of X and Y is Rs. 60 per unit and Rs. 40 per unit, respectively. Calculate the closing stock of X and Y products.

Question 12

X Co. Limited purchased goods at the cost of ` 40 lakhs in October, 2016. Till March, 2017, 75% of the stocks were sold. The company wants to disclose closing stock at ` 10 lakhs. The expected sale value is ` 11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.2017.

Solution

As per AS 2 (Revised) "Valuation of Inventories", the inventories are to be valued at lower of cost or net realisable value.

In this case, the cost of inventory is ` 10 lakhs. The net realisable value is 11,00,000 × 90% = ` 9,90,000. So, the stock should be valued at ` 9,90,000.

Question 13

The company X Ltd., has to pay for delay in cotton clearing charges. The company up to 31.3.2014 has included such charges in the valuation of closing stock. This being in the nature of interest, X Ltd. decided to exclude such charges from closing stock for the year 2014-15. This would result in decrease in profit by ` 5 lakhs. Comment.

Answer

As per para 12 of AS 2 (revised), interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are therefore, usually not included in the cost of inventories. However, X Ltd. was in practice to charge the cost for delay in cotton clearing in the closing stock. As X Ltd. decided to change this valuation procedure of closing stock, this treatment will be considered as a change in accounting policy and such fact to be disclosed as per AS 1. Therefore, any change in amount

mentioned in financial statement, which will affect the financial position of the company should be disclosed properly as per AS 1, AS 2 and AS 5.

Also a note should be given in the annual accounts that, had the company followed earlier system of valuation of closing stock, the profit before tax would have been higher by

` 5 lakhs.

Question 14

On 31st March 2013 a business firm finds that cost of a partly finished unit on that date is

` 530. The unit can be finished in 2013-14 by an additional expenditure of ` 310. The finished unit can be sold for ` 750 subject to payment of 4% brokerage on selling price. The firm seeks your advice regarding the amount at which the unfinished unit should be valued as at 31st March, 2013 for preparation of final accounts.

Answer

Valuation of Work In Progress Inventory:

	`
Net selling price	750
Less: Estimated cost of completion	(310)
	440
Less: Brokerage (4% of 750)	(30)
Net Realisable Value	410
Cost of inventory	530
Value of inventory (Lower of cost and net realisable value)	410

Question 15

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

Raw material X: Closing balance	500 units
Cost price including excise duty	200
Excise duty (Cenvat credit is receivable on the excise duty paid)	10
Freight inward	20
Unloading charges	10

Replacement cost	150
Finished goods Y: Closing Balance	1200 units
	` per unit
Material consumed	220
Direct labour	60
Direct overhead	40

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

Calculate the value of the closing stock, when

(i) Net Realizable Value of the Finished Goods Y is ` 400.

(ii) Net Realizable Value of the Finished Goods Y is ` 300.

Answer

Situation (i)

When Net Realisable Value of the Finished Goods Y is ` 400. NRV is greater than the cost of Finished Goods Y i.e. ` 330 Hence, Raw Material and Finished Goods are to be valued at cost.

Value of Closing Stock:

	Qty	Rate	Amount (`)
Raw Material X	500	220	1,10,000
Finished Goods Y	1,200	330	3,96,000
Total Cost of Closing Stock			5,06,000

Situation (ii) When Net Realisable Value of the Finished Goods Y is ` 300. NRV is less than the cost of Finished Goods Y i.e. ` 330 Hence, Raw Material is to be valued at replacement cost and Finished Goods are to be valued at NRV since NRV is less than the cost.

Value of Closing Stock:

	Qty	Rate	Amount (`)
Raw Material X	500	150	75,000
Finished Goods Y	1,200	300	3,60,000
Total Cost of Closing Stock			4,35,000

Working Notes:

Raw Material X	`
Cost Price	200
Less: Cenvat Credit	(10)
	190
Add: Freight Inward	20
Unloading charges	10
Cost	220
Finished goods Y	`
Materials consumed	220
Direct Labour	60
Direct overhead	40
Fixed overheads (` 2,00,000/20,000 units)	10
Cost	330

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

Question 16

Mr. Mehul gives the following information relating to items forming part of inventory as on 31-3-2015. His factory produces Product X using Raw material A. The following information is provided to you:

a. 600 units of Raw material A (purchased @ ` 120). Replacement cost of raw material A as on 31-3-2015 is ` 90 per unit.

b. 500 units of partly finished goods in the process of producing X and cost incurred till date ` 260 per unit. These units can be finished next year by incurring additional cost of ` 60 per unit.

c. 1500 units of finished Product X and total cost incurred ` 320 per unit. Expected selling price of Product X is ` 300 per unit.

Determine how each item of inventory will be valued as on 31-3-2015. Also calculate the value of total inventory as on 31-3-2015.

Answer:

Valuation of Total Inventory as on 31.03.2015:

	Units	Cost (`)	NRV/Replacement cost	Value = Units x Cost or NRV whichever is less (`)
Raw material A	600	120	90	54,000
Partly finished goods	500	260	240	1,20,000
Finished goods X	1,500	320	300	4,50,000
Value of Inventory				6,24,000

4 AS 4 CONTINGENCIES & EVENTS OCCURRING AFTER BALANCE SHEET DATE

1. Applicability:

The Standard is applicable to all enterprises.

2. Events occurring after the balance sheet date:

These are significant events, both favourable and unfavourable, that occur between the balance sheet date and date on which the financial statements are approved by the Board of directors, in case of a company, and by the corresponding approving authority, in case of other entities.

3. Events Occurring after balance sheet date can be classified into:

(a) Those which provide further evidence of conditions that existed at the balance sheet date. These are called **Adjusting Events**. The full effect of these events is adjusted in our financial statements. No matter that they have arose after the balance sheet date.

(b) Those which are indicative of conditions that arose subsequent to the balance sheet date. These are called Non Adjusting Events. Their effect is not adjusted in the financial statements but their details are provided in the notes to accounts so that the user of the financial statement can have full knowledge about the effects of the events.

4. Exceptions for Non Adjusting Events:

There are two transactions which are treated as Adjusting events even though they are actually Non Adjusting Events, as per the rules of this Accounting Standard:

(a) Proposed Dividend:

Even though dividend is proposed after balance sheet date, but it is still adjusted in the financial statements of current year.

(b) Going Concern Assumption:

If there has been some event due to which the going concern assumption of the entity has ceased to exist, then in that condition, such event will be treated as Adjusting event, even though as per circumstances that is actually non adjusting event as per the rules of this Accounting Standard.

5. Events which are neither disclosed nor adjusted:

No adjustment or disclosure is required in following cases:

(a) If an event takes place after the approval of financial statements by Board of Directors or corresponding authority. It is not an event occurring after balance sheet date as per definition.

(b) Also, no disclosure is required in case an event do not affect balance sheet figures. These events may be disclosed in Directors' Report

6. Disclosure Requirements:

Following are required to be disclosed:

(a) Nature of event.

(b) Estimate of financial effect/Statement of fact that estimate cannot be made.

Practical Problems

Question 1

Cashier of A-One Limited embezzled cash amounting to ` 6,00,000 during March, 2012. However same comes to the notice of company management during April, 2012 only. Financial statements of the company are not yet approved by the Board of Directors of the company. With the help of provisions of AS 4 "Events Occurring after the Balance Sheet Date" decide, whether the embezzlement of cash should be adjusted in the books of accounts for the year ending March, 2012?

What will be your reply, if embezzlement of cash comes to the notice of company management only after approval of financial statement by the Board of Directors of the company?

Answer :

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

Two types of events can be identified:

(a) Adjusting events : those which provide further evidence of conditions that existed at the balance sheet date

(b) Non-adjusting events : those which are indicative of conditions that arose subsequent to the balance sheet date.

In case of adjusting events, loss should be accounted for and the relevant assets and liabilities adjusted.

Therefore, in the present case, the embezzlement of cash amounting to `6,00,000 which occurred during March 2012, notice of which came to the management during April 2012, i.e., before the approval of financial statement by the Board of Directors of the company, should be adjusted in the cash balances as on 31st March 2012 and loss should be accounted for.

If the embezzlement of cash comes to the notice of company management only after approval of financial statements by the Board of Directors of the company, then it is non-adjusting event and only a disclosure should be given in the Directors Report.

Question 2

While preparing its final accounts for the year ended 31st March, 2010, a company made a provision for bad-debts @ 4% of its total debtors (as per trend followed from the previous year). In the first week of March 2010 a debtor for Rs. 3,00,000 had suffered heavy loss due to

an earthquake; the loss was not covered by any insurance policy. In April 2010 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2010. Or

MEC Limited could not recover an amount of Rs. 8 lakhs from a debtor. The company is aware that the debtor is in great financial difficulty. The accounts' of the company for the year ended 31.03.2011 were finalized by making a provision @ 25% of the amount due from that debtor. In May 2011, the debtor became bankrupt and nothing' is recoverable from him. Do you advise the company to provide for the entire loss of Rs. 8 lakhs in books of account for the year ended 31.03.2011?

Answer :

According to AS 4 on 'Contingencies and Events Occurring After the Balance Sheet Date', in case additional information is available in respect of conditions existing on the balance sheet date, adjustment is required to assets/liabilities if any significant event occurs after the Balance Sheet date but before the date of approval of financial statements by the Board.

In the present case, sundry debtors as on 31.03.2010 should be suitably adjusted by providing for the entire amount due from the debtor who has become bankrupt as nothing is recoverable from him. The amount is required to be adjusted, as in this case, the conditions existed on the balance sheet date in respect of which additional evidence has been provided by the bankruptcy of the debtor.

Question 3

In Raj Co. Ltd., theft of cash of Rs. 2 lakhs by the Cashier in January, 2010 was detected in May, 2010. 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 31.03.2010. Decide.

Answer :

AS 4 'Contingencies and Events occurring after the Balance Sheet Date' provides that an event occurring after the balance sheet date may require adjustment to the reported values of assets, liabilities, expenses or incomes, if it is just providing additional evidences of the conditions already existing on the balace sheet date.

This embezzlement of cash has been detected in May, before approval of financial statements whereas the cash was stolen before 31st march. Therefore the condition of this loss by theft existed on the balance sheet date. Having regard to this we need to adjust this loss in our financial statements for the year ending 31.3.2010.

Question 4

An earthquake destroyed a major warehouse of ACO Ltd. on 20.05.2009. The accounting year of the company ended on 31.03.2009. The accounts were approved on 30.06.2009. The loss from earthquake is estimated at Rs. 30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company?

Answer :

The above situation is based on AS 4 on 'Contingencies and events occurring after the Balance Sheet Date.

The standard requires adjustments to assets and liabilities for the following types of events:

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

(b) Those which indicate that the fundamental assumption of going concern (ie, the continuance of existence or substratum of the enterprise);

The present events do not relate to condition existing at the balance sheet date. Hence, no specific adjustment is required in the financial statements. However, AS 4 requires disclosure in respect of post balance sheet events representing unusual changes affecting the existence of the enterprise at the balance sheet date.

In the present case, if the loss from earthquake can be considered to be an event effecting the existence of the entity and the going concern assumption has ceased to exist then adjustment will be needed in the financial statements.

Question 5

The Financial Controller of AS Limited refuses to provide for proposed dividend in books of accounts for the year ended 31.03.2007 on the ground that it is pending approval of shareholders in Annual General Meeting to be held on 16th September, 2007.

Answer :

AS 4 on ‘Contingencies and Events Occurring after the Balance Sheet Date’ specifies two types of events - adjusting events and non-adjusting events. Adjusting events are the events that require adjustments to assets and liabilities. These are the events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date, e.g., an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

Adjusting events also include such events which are required to be disclosed because of statutory requirements or because of their special nature, eg, dividend proposed by an enterprise after the balance sheet date. In view of specific provision of AS 4 in this regard, the contention of the financial controller of AS Ltd. is wrong. Hence, proposed dividend should be provided in the books of accounts for the year ended 31.03.2007.

Question 6

X Ltd. entered into an agreement to sell its immovable property included in the Balance Sheet at Rs. 10 lacs to another company for Rs. 15 lacs. The agreement to sell was concluded on 28th February, 2006 and sale deed was registered on 1st May, 2006. Comment with reference to AS 4.

Answer :

X Ltd. should recognise the sale and gain at the balance sheet date. It is clearly evident that significant risks and rewards of ownership have passed before the balance sheet date and the delay in transfer of property was merely due to formality involved in getting the transfer deed registered. Further, the registration after the balance sheet date confirms the conditions of sale at the balance sheet date as laid out in AS 4.

Question 7

ABC Ltd. could not recover Rs. 10 lakhs from a debtor. The company is aware that the debtor is in great financial difficulty. The accounts of the company were finalized for the year ended 31.03.2005 by making a provision @ 20% of the amount due from the said debtor. The debtor became bankrupt in April, 2005 and nothing is recoverable from him.

Do you advise the company to provide for the entire loss of Rs. 10 lakhs in the books of account for the year ended 31st March, 2005?

Answer :

According to AS 4 on 'Contingencies and Events Occurring After the Balance Sheet Date', in case additional information is available in respect of conditions existing on the balance sheet date, adjustment is required to assets/liabilities if any significant event occurs after the Balance Sheet date but before the date of approval of financial statements by the Board.

In the present case, sundry debtors balance as on 31.03.2005 should be suitably adjusted by providing for the entire amount due from the debtor who has become bankrupt as nothing is recoverable from him. The amount is required to be adjusted as in this case the conditions existed on the balance sheet date in respect of which additional evidence has been provided by the bankruptcy of the debtor.

Question 8

As on 31.03.2005, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide satisfactory after-sales services in relation to the software purchased from it. Before finalization of the accounts for the year ended 31.03.2005 (the accounts were finalised on 14 June, 2005), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 31-3-2005, which, it says, will be reversed in the next year.

Answer :

The present case falls into the category of adjusting events. In the present case, on 31.03.2005, there was a claim against the company for damages by a customer for not providing after sales service. It is a condition prevailing as on the date of balance sheet. The company had provided for the contingent liability perhaps in view of the expectation that such a claim may crystallize as liability against it. The winning of the case by the company in its favour (before the accounts were approved) after the date of the balance sheet constitutes additional evidence that will be of help in deciding the treatment of the matter in the accounts as per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date". However, no provision would be needed as the case had been won by the company, since confirmed by subsequent event happening after the balance sheet date. The disclosure of facts of the case is, however, necessary with a view

to keeping users of financial statements informed about the nature of event as well as the fact that no provision is necessary.

Question 9

During the year 2015-2016, Raj Ltd. was sued by a competitor for ` 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of ` 10 lakhs in its financial statements for the year ended 31st March, 2016. On 18th May, 2016, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of` 14 lakhs. The financial statements were prepared by the company's management on 30th April, 2016, and approved by the board on 30th May, 2016.

Answer:

As per AS 4 (Revised), adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 2015-16 for which the provision was also made by it, the decision of the Court on 18th May, 2016, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by ` 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Had the judgment of the Court been delivered on 1st June, 2016, it would be considered as an event occurring after the approval of the financial statements which is not covered by AS 4 (Revised). In that case, no adjustment in the financial statements of 2015-16 would have been required.

Question 10

Sundry debtors of a company as on 31.03.2003 include Rs. 10 lakhs from M/s. Unreliable Traders, who have been declared as insolvent on 04.04.2003. Comment.

Answer :

According to AS 4 on ‘Contingencies and Events Occurring After the Balance Sheet Date’ in case additional information is available in respect of conditions existing on the balance sheet

date, adjustment is required to assets/liabilities if any significant event occurs after the Balance Sheet date but before the date of approval of financial statements by the Board.

In the present case, sundry debtors balance as on 31.03.2003 should be suitably adjusted since the conditions existed on the balance sheet date in respect of which additional evidence has been provided by the insolvency of M/s. Unreliable Traders.

Question 11

You are an accountant preparing accounts of A Ltd. as on 31.03.2003. After year end the following events have taken place in April, 2003:

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

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

(iii) Dividend proposed @ 20% on share capital of Rs. 100 lakhs.

Describe, how above will be dealt with in the account of the company for the year ended on 31.03.2003.

Answer :

According to AS 4 Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and, by the corresponding approving authority in the case of any other entity.

Para 15 of AS 4 requires disclosure of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, in the report of the approving authority. Hence, fire incident and loss thereof should be disclosed in the Directors' Report.

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

So far as proposed dividend is concerned, AS 4 specifically requires an adjustment in respect of proposed dividend. Thus, proposed dividend needs to be adjusted in the financial statements of the year ended 31.03.2003.

Question 12

In preparing the financial statements of R Ltd. for the year ended 31st March, 2017, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2017 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Answer:

AS 4 (Revised) defines "Events Occurring after the Balance Sheet Date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Approving Authority in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2017. Applying AS 4 (Revised) which clearly states that disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ` 100 lakhs in April, 2017 in the acquisition of another company should be disclosed in the report of the Approving Authority to enable users of financial statements to make proper evaluations and decisions.

Question 13

A Limited Company closed its accounting year on 30.6.2017 and the accounts for that period were considered and approved by the board of directors on 20th August, 2017. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2017 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ` 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.2017.

Answer

AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and

unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'.

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

5 AS 5 Net Profit Or Loss For The Period, Prior Period Items & Changes In Accounting Policies

1. **Applicability:**

The Standard is applicable to all enterprises.

2. **Meaning**

   a. **Ordinary activities :**

   The 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.

   b. **Extraordinary items:** Income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise, and therefore, are not expected to recur frequently or regularly.

   c. **Prior period items:** 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.

3. **Presentation of Ordinary Items and Extra Ordinary Items:**

   a. The profit and loss account should include all items of income or expense for the period such as :

      # Ordinary Items

      # Extra Ordinary Items

      # Prior Period Items

      # Change in Accounting Estimates

      # Change in Accounting Policies

   b. Separate disclosure for items of income or expense within profit & loss account from ordinary activities, which are of such **significant size, nature or incidence** that their disclosure is relevant to explain the performance of an enterprise. As per Schedule 3 of Companies Act 2013, these are called exceptional items.

   c. Separate disclosure is always needed for all the Extra Ordinary Items, no matter their nature, size or incidence is significant or not, so that user could easily understand the nature and effect of such Extra Ordinary Item on the Profit and Loss of the entity.

4. **Prior Period Items:**

a. Prior period items refer to only those items of income or expenses which arise in the current period as a result of errors or omissions, during one or more prior periods. Prior period items do not include those items, which though related to prior periods, are determined in the current period.

   Example: Revision of wages in current year with retrospective effect.

b. Separate disclosure of prior period items, their nature and amount, in such a manner, so that their impact on current profit & loss can be perceived,

c. The best way is to calculate the profit before adjusting prior period items and profit after adjusting prior period items.

5. Changes in Accounting Policies:

a. Accounting Policies is allowed to be changed only if it is required:

   # By Statue

   # For compliance of Accounting Standard

   # For more appropriate presentation of financial statements

b. In case, any change in accounting policy has material effect in current year or is likely to have effect in future, then the fact of change should be disclosed.

c. The impact on financial statements due to change in accounting policy should be disclosed.

d. In case, the impact on financial statements cannot be ascertained, then, the fact should be disclosed.

6. Changes in Accounting Estimates:

a. Accounting Estimates are required in number of cases, for example, useful lives of depreciable assets, salvage value of assets, inventory obsolescence etc.

b. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information or subsequent developments.

c. If change in estimate affects current period, consider its impact in determination of current year profit & loss, such as provision for doubtful debt.

d. If change in estimate affects current period & future periods, consider is impact in determination of profit & loss of all such periods, such as change in useful life of the asset.

e. The change in accounting estimate must be classified in the same manner as it was originally classified when the initial estimate was made. It means if original estimate

was classified as ordinary item then the change in estimate will also be classified as ordinary item. If the original estimate was classified as extra ordinary item then change in estimate will also be classified as extra ordinary item.

f. The change in Accounting estimate is not a prior period item. Because it is not arising as a result of any error or omission in one or more prior periods.
g. If the amount of effect of change in estimate can't be made then this fact must be disclosed.

Practical Problems

Question 1

Tiger Motor Car Limited signed an agreement with its employees union for revision of wages on 01.07.2011. The revision of wages is with retrospective effect from 01.04.2003. The arear wages up to 31.03.2011 amounts to Rs. 40,00,000 and that for the period from 01.04.2011 to 01.07.2011 amount to Rs. 3,50,000, In view of the provision of AS 5 "Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies", decide whether a separate disclosure of arrear wages is required while preparing financial statements for the year ending 31.03.2012.

Answer :

Additional wages, in the present case, falls under the category of an expense arising from the ordinary activities of the company. The entire additional wages liability of Rs. 43,50,000 should be included in current year's wages. It is pertinent to note here that the wages payable for the previous year cannot be treated as a prior period item as there has been no error or omission in the preparation of financial statements of the previous year. Similarly, the nature of expense is not such that can be treated as an extraordinary item.

So far as the question of disclosure is concerned, AS 5 on 'Net profit or loss for the period, prior period items and changes in accounting policies' requires that when items of income and expense within profit or loss from ordinary activities are of size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the reporting period, the nature and amount of such items should be disclosed separately. Hence, disclosure is necessary for the amount paid in 2011-12.

Question 2

Closing stock for the year ending on 31.03.2010 is Rs. 50,000 which includes stock damaged in a fire in 2008-09. On 31.03.2009, the estimated net realizable value of the damaged stock was Rs. 12,000. The revised estimate of net realizable value of damaged goods amounting Rs. 4,000 has been included in closing stock of Rs. 50,000 as on31.03.2010.

Find the value of closing stock to be shown in Profit and Loss Account for the year 2009-2010.

Answer :

The change in the estimate of net realizable value of damaged stock is to be treated as a change in an accounting estimate under AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

Then, the value of closing stock for the year 2009-10 will be as under:

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

Question 3

The company finds that the stock sheets of 31.03.2007 did not include two pages containing details of inventory worth Rs. 20 lakhs. State, how you will deal with this matter in the accounts of A Ltd. for the year ended 31st March, 2008 with reference to AS 5.

Answer :

The omission to include two pages containing details of inventory worth Rs. 20 lakhs in the stock sheets of 31.03.2007 constitutes 'prior-period item'. AS 5 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. The company should pass the following journal entry:

	Rs. lakhs
Dr. Opening Inventory (1.04.2007)	20
Cr. Prior period Income	20

A Ltd. should separately disclose the nature and amount of this prior period item in the profit and loss account for the year ended 31.03.2008.

Question 4

Finished goods costing worth Rs. 10 lacs were damaged due to floods in July, 2004. These goods were included in the closing stock as on March 31, 2005 at an estimated realizable value of Rs. 4 lacs. These goods, ultimately, could be sold for Rs. 3 lacs only in the accounting year 2005-06. The difference of Rs. 1 lac was debited to prior period expenditure in the accounting year 2005-06. Comment

Answer :

This problem is based on AS 5. The standard defines a prior period item 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.

Prior period items should be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information become known or the transaction is finally settled.

In the instant case there is no error or omission in prior periods. It is a case of accounting estimates which have changed when the damaged goods have been finally sold.

Thus the difference of Rs. 1 lac should be treated as a change in an accounting estimate and not prior period item.

Question 5

The Company X Ltd. has to pay for delay in Cotton clearing charges. The company upto 31.03.2006 has included such charges in the valuation of Closing stock. This being in the nature of interest, X Ltd. decided to exclude such charges from Closing stock for the year 2006-07. This would result in decrease in profit by Rs. 5 lakhs. Comment.

Answer :

This issue is based on AS 5 on 'Net Profit or Loss for the period, prior period items and changes in accounting policies' issued by ICAI. The standard lays down the circumstances in which an enterprise can change its accounting policy, one of them being to comply with an Accounting Standard. Such a change in an accounting policy needs to be suitably disclosed.

In the present case, exclusion of interest from valuation of closing stock has been done in order to comply with the requirements of AS 2. Hence, the change is in conformity with the requirements of AS 5. For this purpose, the following disclosure should be given in the financial statements for the year 2006-07 by way of notes to accounts:

"The company has excluded interest from the valuation of closing stock unlike preceding years, to be in conformity with the AS 2 on 'Valuation of Inventories', issued by ICAI. Had the same principle been followed as in previous years, profits for the year would have increased by Rs. 5 lakhs and consequently net assets would have been higher by Rs. 5 lakhs."

Question 6

The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately.

Answer :

AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" lays down the classification and disclosure of items in the statement on profit and loss account. It requires separate disclosure of prior period item, extraordinary items, etc. distinctly so as to reflect the financial position of enterprise for better understanding of users of financial statements. In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses 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 auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.

Question 7

M/s Bonafide Ltd. has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2004-05 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2003-04 was less charged by Rs. 75 lacs on account of arithmetical error on the part of Insurance Company. M/s Bonafide Ltd. paid the said sum of Rs. 75 lacs during the accounting year 2004-05 by debiting the same to Prior Period Expenses.

Answer :

AS 5 defines a 'prior-period item' as income or expense which arises in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. In this case, there has been arithmetical mistake of Rs. 75 lacs in computing the amount of premium. Though in this case there was no error or omission on the part of M/s Bona fide and the error was on the part of the Insurance company, but it is the management of the enterprise which is responsible for preparation of financial statements. Thus, the expenditure of Rs. 75 lacs pertains to prior period and to be debited to Prior Period Expenses. Therefore, the accounting treatment accorded by the management is appropriate. The auditor should ensure that the nature of mistake, ie, insurance premium as well as amount of Rs. 75 lacs has been disclosed separately in such a manner that its impact on the current profit or loss can be perceived.

Question 8

A limited company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2003-04.

Subsequently on a review of the credit period allowed and financial capacity of the customers, the company decided to increase the provision to 8% on Debtors as on 31.03.2004. The accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard can this revision be considered as an extraordinary item or prior period item?

Answer :

The increase in the provision for bad and doubtful debts from 2.5% to 8% can neither be considered as an extraordinary item nor a prior period item. AS 5 defines the terms 'Extraordinary Items' as income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and are, therefore, not expected to recur frequently or regularly and '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.

The present revision is arising clearly from ordinary activities of the enterprises. Also, it is not on account of any error or omission in the preparation of financial statements of prior period. The said increase is a change in a financial accounting estimate.

An accounting estimate means determination of an amount. The determination is normally based on judgments taken on the basis of latest information available, eg, estimation of bad debts, estimation of useful lives of depreciable assets, etc. Such estimates may need revision as additional information becomes known.

Thus, the increase in the provision for bad and doubtful debts is neither an extraordinary item nor a prior period item, instead is a change in an accounting estimate. The nature and amount of this change should be disclosed appropriately in the financial statements for the year 2003-04.

Question 9

Asian Overseas Oil Ltd's oil wells were damaged in Iraqi war in November, 2002. Claim preferred with the Insurance Companies for total loss. Pending the settlement by the Insurance

Companies neither any provision nor any disclosure has been made in 2002-03 accounts. Comment.

Answer :

This problem is based on AS 4 and AS 5. In the present case, the oil wells have been damaged and the amount of insurance claim in respect thereof is not determinable till the end of the accounting year. Hence, the resultant loss should be provided for in accordance with AS 4. The provision for loss should be reduced by the probable recovery through insurance claim, provided the claim is reasonably certain to be received.

Since, the loss is not expected to recur frequently or regularly, it should be disclosed as an extraordinary item as per AS 5.

Question 10

As a Company Auditor how will you react to the following situations:

(i) Sale value of scrap items adjusted against Miscellaneous Expenditure.

(ii) Insurance claim of Rs. 2 lakhs received stands included under Miscellaneous Income.

Answer :

AS 5 provides 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. In view of this,

(i) Adjusting sale value of scrap against miscellaneous expenditure is not proper as sale value of scrap is an item of miscellaneous income. As an auditor we need to ensure that the revenue has been disclosed properly in the financial statement such an adjustment would fail to explain the performance of the company.

(ii) Money received from the insurance company is against a specific loss. It should be adjusted against the loss. As an auditor, we need to check the adjustment of the amount received in short of the value of actual loss as per the insurance policy. Profit and Loss Account should be debited with the shortfall of the claim against the book value. If the claim was lodged in the previous year but no entries were passed at that time, entries in the profit and loss account should be described appropriately.

Question 11

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

Answer :

The present situation is based as AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. The Standard requires that all items of income and expense that are recognised in a period should be included in the determination of net profit or loss for the period. In the present case, the claim for loss of goods in transit is arising out of ordinary activities. However, having regard to the amount involved and exceptional nature, a separate disclosure should be made in the profit and loss account. The entire amount of Rs. 10,00,000 should be taken to Profit and Loss Account under the appropriate head. Credit to purchase account would not be appropriate as it would distort the purchases made during the year and consequently the gross profit.

Question 12

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

Answer :

The treatment adopted by the auditee is inappropriate Embezzlement of cash during the course of business is a business loss - a business hazard that can occur once in a while.

It is necessary to disclose such item separately rather than merging them with other items, AS 5 provides 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.

Since, the amount of embezzlement is material, it should be disclosed separately under a distinct head in Profit and loss account.

Question 13

Z Ltd. provided Rs. 5 lakhs for inventory obsolescence in the last year's accounts. In the subsequent year, it was determined that 50% of this stock was actually usable. The company wants to adjust the same as a "Prior period adjustment".

Answer

This problem is based on AS 5. The Standard provides that an accounting estimate means determination of an amount. The determination is normally based on judgments taken on the basis of latest information available, eg, estimation of bad debts, estimation of useful lives of depreciable assets, etc. Such estimates may need revision as additional information becomes known, eg, information about a change in technology may change the estimate of useful life of a depreciable asset. Prior period items, on the other hand, are items of income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of prior periods. To illustrate, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably will be classified as a change in an accounting estimate whereas if additional income or expense need to be recognised in the current period due to a mathematical mistake in the amount of income or expense (as the case may be) will fall in the category of prior period items.

The subsequent discovery of the fact that 50% of the inventory, for which provision was made in the last year, thus, cannot be treated as a prior period item. It should be treated as a change in an accounting estimate and disclosed accordingly.

Question 14

As an auditor state your views on the following situation:

X Ltd. prior to receipt of their management consultants' suggestions, had been valuing its stock consistently, by adding factory overheads to its prime cost. The consultants had recommended a better procedure which would ensure a fair allocation of overheads. The company intends to adopt the new basis but unwilling to accept the fact that this was a change in the basis as staed by their consultants.

Answer

In the present case, the method followed by X Ltd. of valuing stocks by adding factory overheads to prime cost on a consistent basis is proposed to be modified by shifting to another basis to ensure fair allocation of overheads. An entity is not required to disclose any change from one generally accepted method of accounting to another in its financial statements unless such change has material effect in the current period or which is reasonably expected to have a material effect in later periods. It appears from the facts of the case that, X Ltd, merely brought about a refinement in the application of a generally accepted accounting method which

neither amounts to a change in an accounting policy nor does the effect on financial statements appears to be material. By following a better procedure suggested by management consultants, the new procedure would ensure fair allocation of overheads. Thus, the view point of the company that this would not amount to change in the basis of accounting appears to be correct.

Question 15

A limited company has been including interest in the valuation of closing stock. In 2001-02, the management of the company decided to follow AS 2 and accordingly interest has been excluded from the valuation of closing stock. This has reslted in a decrease in profits by Rs. 3,00,000. Is a disclosure necessary? If so, draft the same.

Answer

This issue is based on AS 5 on "Net Profit or Loss for the period, prior period items and changes in accounting policies", issued by ICAI. The Standard lays down that the circumstances in which an enterprise can change its accounting policy, one of them being to comply with an Accounting Standard. Such a change in an accounting policy, beeds to be suitably disclosed.

In the present case, exclusion of interest from valuation of closing stock has been done in order to comply with the requirements of AS 2. Hence, the change is in conformity with the requirements of AS 5. For this purpose, the following disclosure should be given in the financial statements for the year 2001-02 by way of notes to accounts:

"The company has excluded interest from the valuation of closing stock unlike preceding years, to be in confirmation with the AS 2 on 'Valuation of Inventories', issued by ICAI. Had the same principle been followed as in present years, profits for the year would have increased by Rs. 3,00, 000 and consequently net assets would have been higher by Rs. 3,00,000."

Question 16

S.T.B. Ltd. makes provision for expenses worth ` 7,00,000 for the year ending March 31, 2011, but the actual expenses during the year ending March 31, 2012 comes to ` 9,00,000 against provision made during the last year. State with reasons whether difference of ` 2,00,000 is to be treated as prior period item as per AS-5.

Answer:

As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', as a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Estimates may have to be revised, if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments.

As per the standard, 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. Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Thus, revision of an estimate by its nature i.e. the difference of ` 2 lakhs, is not a prior period item.

Therefore, in the given case expenses amounting ` 2,00,000 (i.e. ` 9,00,000 – ` 7,00,000) relating to the previous year recorded in the current year, should not be regarded as prior period item.

Question 17

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

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

Answer

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the change in amount of staff welfare provision amounting

` 25,000 is neither a prior period item nor an extraordinary item. It is a change in estimate, which has been occurred in the year 2010 - 11.

As per the provisions of the standard, normally, all items of income and expense which are recognized in a period are included in the determination of the net profit or loss for the period.

This includes extraordinary items and the effects of changes in accounting estimates. However, the effect of such change in accounting estimate should be classified using the same classification in the statement of profit and loss, as was used previously, for the estimate.

6 REVISED AS 10 PROPERTY PLANT AND EQUIPMENT

1. This Standard should be applied in accounting for property, plant and equipment except when another Accounting Standard requires or permits a different accounting treatment.

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

2. This Standard does not apply to:

(a) Biological assets related to agricultural activity other than bearer plants. This Standard applies to bearer plants but it does not apply to the produce on bearer plants; and

(b) Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

3. This Standard applies to property, plant and equipment used to develop or maintain the assets described in 2(a) and (b) above.

4. **Property, plant and equipment are tangible items that:**

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than a period of twelve months.

5. **Agricultural Activity** is the management by an enterprise of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

6. **Agricultural Produce** is the harvested product of biological assets of the enterprise.

7. **Bearer plant is a plant that**

(a) is used in the production or supply of agricultural produce;

(b) is expected to bear produce for more than a period of twelve months; and

(c) has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

8. The following are not bearer plants:

(i) Plants which are cultivated to be sold as agriculture produce. Such as we grow trees to be sold as lumber.

(ii) Plants which are cultivated to be sold as lumber as well as to produce agriculture produce. Such as we have grown mango trees to grow mangoes and also sell the timber of such tree.

(iii) annual crops (for example, maize and wheat).

9. **Biological Asset** is a living animal or plant.

10. Recognition as an Asset :

The cost of an item of property, plant and equipment should be recognised as an asset if, and only if:

a. It is probable that future economic benefits associated with the item will flow to the enterprise; and

b. The cost of the item can be measured reliably.

11. Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Standard when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

12. It may be appropriate to aggregate to individually insignificant items, such as moulds, tools and dies and to apply the criteria to the aggregate value.

13. An enterprise may decide to expense an item which could otherwise have been included as PPE, because the amount of the expenditure is not material.

14. When do we apply the above criteria for Recognition?

a. When cost is incurred to acquire or construct an item of PPE

b. When cost is incurred to add to, replace part of, or service it.

15. Treatment of subsequent costs :

a. **Cost of day to day servicing**

(i) **Meaning :** Cost of day-to-day servicing are primarily the costs of labour and consumables. And may include the cost of small parts. The purpose of such expenditures is often described as for the 'Repairs and Maintenance' of the item of PPE.

(ii) **Accounting Treatment :** An enterprise does not recognize in the carrying amount of an item of PPE the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the Statement of Profit and Loss as incurred.

b. **Replacement of Parts of PPE**

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

Examples:

1. A furnace may require relining after a specified number of hours of use.
2. Aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.
3. Major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system.
4. Replacing the interior walls of a building, or to make a non-recurring replacement.

Accounting Treatment :

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

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

c. **Regular Major Inspections - Accounting Treatment**

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

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

16. Measurement At Recognition

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

17. Cost of an item of Purchased PPE :

Cost of an Item of PPE

(a) Includes

(i) Purchase Price

(ii) Any Directly Attributable Costs

(iii) Decommissioning, Restoration and similar Liabilities

(b) Excludes

(i) Costs of opening a new facility or business (Such as, Inauguration costs)

(ii) Costs of introducing a new product or

(iii) service (including costs of advertising and promotional activities)

(iv) Costs of conducting business in a new location or with a new class of customer (including costs of staff training)

(v) Administration and other general overhead costs

Note 1 :

Purchase Price :

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

Note 2 :

Directly Attributable Costs:

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

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

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

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

Note 3 : Directly attributable costs are:

1. Costs of employee benefits (as defined in AS 15) arising directly from the construction or acquisition of the item of PPE
2. Costs of site preparation
3. Initial delivery and handling costs
4. Installation and assembly costs
5. Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)
6. Professional fees

Note 4 : Costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility or business, such as, inauguration costs

(b) costs of introducing a new product or service(including costs of advertising and promotional activities)

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training)

(d) administration and other general overhead costs

Note 5 : Items which are incidental but not to be included in cost :

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

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

Note 6 : Decommissioning, Restoration and similar Liabilities:

Initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as ‘Decommissioning, Restoration and similar Liabilities’, the obligation for which an enterprise incurs either when the item is acquired or as a consequence

of having used the item during a particular period for purposes other than to produce inventories during that period.

18. Cost of a Self-Constructed Asset

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

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

19. Measurement of Cost

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

(a) If payment is deferred beyond normal credit terms:

Total payment minus Cash price equivalent

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

(b) PPE acquired in Exchange for a Non-monetary Asset or Assets or A combination of Monetary and Non-monetary Assets:

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

(i) Exchange transaction lacks commercial substance; Or

(ii) Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

Note 1 : If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.

(c) PPE purchased for a Consolidated Price :

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

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

(d) PPE held by a lessee under a Finance Lease:

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

(e) Government Grant related to PPE:

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

20. Measurement After Recognition

An enterprise should choose as its accounting policy and should apply that policy to an entire class of PPE :

- Either Cost model, Or
- Revaluation model

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

22. Examples of separate classes:

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

23. Cost Model

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

Cost	xxx
Less : Any Accumulated Depreciation	(xxx)
Less : Any Accumulated Impairment losses	(xxx)

	xxx

24. Revaluation Model

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

Fair value at the date of the revaluation	xxx
Less: Any subsequent accumulated depreciation	(xxx)
Less: Any subsequent accumulated impairment losses	(xxx)
Carrying value	xxx

25. Revaluation for entire class of PPE

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

Reason :

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

26. Frequency of Revaluations

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

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

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

(a) Items of PPE experience significant and volatile changes in Fair value

Annual revaluation should be done.

(b) Items of PPE with only insignificant changes in Fair value

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

27. Determination of Fair Value

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

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

Example :

Based on

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

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

28. Accounting Treatment of Revaluations

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

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

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

Gross carrying amount

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

Accumulated depreciation at the date of the revaluation is

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

Case Study on Technique I

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

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

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600

Fair Value			1,500
Revaluation Gain			900
Gain allocated proportionately to cost and depreciation	1,500	600	900
PPE after revaluation	2,500	1,000	1,500

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

(b) Technique 2 : Accumulated depreciation Is eliminated against the Gross Carrying amount of the asset

Case Study on Technique II

(Taking the information given in the above Example)

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

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

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

29. Revaluation - Increase or Decrease

- **Increase in Value :**
  - Credited directly to owners' interests under the heading of Revaluation surplus
  - Exception: When it is subsequently Increased (Initially Decreased)
  - Recognised in the Statement of profit and loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in the Statement of profit and loss
- **Decrease in Value :**
  - Charged to the Statement of profit and loss
  - Exception: When it is subsequently Decreased (Initially Increased)

- Decrease should be debited directly to owners' interests under the heading of Revaluation surplus to the extent of any credit balance existing in the Revaluation surplus in respect of that asset

30. Treatment of Revaluation Surplus

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

Case I : When whole surplus is transferred:

When the asset is :

- Retired; Or
- Disposed of

Case II : **Some of the surplus may be transferred as the asset is used by an enterprise:** In such a case, the amount of the surplus transferred would be: Depreciation (based on Revalued Carrying amount) – Depreciation (based on Original Cost)

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

31. Depreciation

a. Component Method of Depreciation:

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

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

b. Is Grouping of Components possible?

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

32. Accounting Treatment of Depreciation :

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

33. Depreciable Amount and Depreciation Period

a. What is "Depreciable Amount"?

Depreciable amount is : Cost of an asset (or other amount substituted for cost i.e. revalued amount) less Residual value. The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

34. Review of Residual Value and Useful Life of an Asset

Residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

35. Commencement of period for charging Depreciation

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

36. Cessesation of Depreciation

(a) Depreciation ceases to be charged when asset's residual value exceeds its carrying amount. The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

(b) Depreciation of an asset ceases at the earlier of:

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

Note 1 : Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated.

Note 2 : Under usage methods of depreciation, the depreciation charge can be zero while there is no production.

Note 3 : Land and buildings are separable assets and are accounted for separately, even when they are acquired together.

Note 4 : Land has an unlimited useful life and therefore is not depreciated. Except quarries and sites used for landfill.

Note 5 : Depreciation on Land will be charged if land itself has a limited useful life. It is depreciated in a manner that reflects the benefits to be derived from it.

Note 6 : If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.

Note 7 : Buildings have a limited useful life and therefore are depreciable assets.

Note 8 : An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

37. Depreciation Method

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

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

a. There is a change in the expected pattern of consumption of those future economic benefits; Or

b. That the method is changed in accordance with the statute to best reflect the way the asset is consumed.

38. Review of Depreciation Method :

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

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

39. Depreciation Method based on Revenue :

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

40. Changes in Existing Decommissioning, Restoration and other Liabilities

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

a. Changes in Liabilities

b. Price Adjustments

c. Changes in Duties

d. Changes in initial estimates of amounts provided for Dismantling, Removing, Restoration, and

e. Similar factors

The above are included in the cost of the asset.

41. Accounting for the above changes :

a. **If the related asset is measured using the Cost model:**

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

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

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

Enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with applicable Accounting standards.

c. **If the related asset is measured using the Revaluation model:**

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

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

Exception:

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

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

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

Exception:

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

Caution:

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

What happens if the related asset has reached the end of its useful life? All subsequent changes in the liability should be recognised in the Statement of Profit and Loss as they occur.

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

42. Retirements

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

(i) Carrying Amount, and

(ii) Net Realisable Value

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

43. De-Recognition

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

a. On disposal

(i) By sale

(ii) By entering into a finance lease, or

(iii) By donation, Or

(iv) When no future economic benefits are expected from its use or disposal

Accounting Treatment:

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

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

  = Net disposal proceeds (if any) - Carrying Amount of the item

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

c. **Exception:**

   An enterprise that in the course of its ordinary activities, routinely sells items of PPE that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9 on Revenue Recognition.

44. Determining the date of disposal of an item:

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

45. General Disclosures :

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

(a) The measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;

(b) The depreciation methods used;

(c) The useful lives or the depreciation rates used.

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

(d) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

(e) A reconciliation of the carrying amount at the beginning and end of the period showing:

- additions
- assets retired from active use and held for disposal
- acquisitions through business combinations
- increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 28
- impairment losses recognised in the statement of profit and loss in accordance with AS 28
- impairment losses reversed in the statement of profit and loss in accordance with AS 28
- depreciation
- net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11
- other changes

46. Additional Disclosures :

The financial statements should also disclose:

(a) The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

(b) The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;

(c) The amount of contractual commitments for the acquisition of property, plant and equipment;

(d) If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and

(e) The amount of assets retired from active use and held for disposal.

47. Disclosures related to Revalued Assets:

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

(a) The effective date of the revaluation;

(b) Whether an independent valuer was involved;

(c) The methods and significant assumptions applied in estimating fair values of the items;

(d) The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and

(e) The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

PRACTICE PROBLEM:

Question 1

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

Answer :

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

Question 2

What happens if the cost of the previous part/Inspection was/was not identified in the transaction in which the item was acquired or constructed?

Answer :

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

Question 3

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

Answer :

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

Question 4

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

1. Setup costs of ` 5,00,000 to install machinery in the new location.

2. Rent of ` 15,00,000

3. Removal costs of ` 3,00,000 to transport the machinery from the old location to the temporary location.

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

Answer :

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

Question 5

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

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

Answer :

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

However, if the cost of salaries, utilities and storage of goods are in the nature of operating expenditure that would be incurred if the supermarket was open, then these costs are not

necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Question 6

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

Answer :

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

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

Question 7

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

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

Question 8

Entity A exchanges car X with a book value of ` 13,00,000 and a fair value of ` 13,25,000 for cash of ` 15,000 and car Y which has a fair value of ` 13,10,000. The transaction lacks commercial substance as the company’s cash flows are not expected to change as a result of

the exchange. It is in the same position as it was before the transaction. What will be the measurement cost of the assets received?

Answer :

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

Question 9

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

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

Answer :

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

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

However, all properties within the class of office buildings must be carried at revalued amount.

Question 10

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

Answer :

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

Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use. Thus, the policy of Entity A is not acceptable.

Question 11

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

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

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

Answer :

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

On 1st January 2017, the asset's net book value is [1,00,000 – (10,000 x 4)] ` 60,000. The remaining useful life is 4 years.

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

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

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

Question 12

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

Answer :

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

Question 13

A property costing ` 10,00,000 is bought in 2016. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years. The estimated residual value in 20 years' time, based on 2016 prices, is:

Case (a) ` 10,00,000 Case (b) ` 9,00,000.

Calculate the amount of depreciation.

Answer :

Case (a)

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

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

Case (b)

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

` 1,00,000.

Annual depreciation (on a straight line basis) will be ` 5,000 [{10,00,000 – 9,00,000} ÷ 20].

Question 14

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

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

Answer :

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

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

Question 15

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

Answer :

Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with AS 10 (Revised). Entity A should separately recognise a receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 (Revised) once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

Question 16

Rama Ltd. Is installing a new plant at its production facility. It has incurred these costs :

	Amt. in `
Cost of the Plant (cost per supplier's invoice plus taxes)	15,00,000
Initial delivery and handling costs	2,00,000
Cost of site preparation	8,00,000

Consultants used for advice on the acquisition of the plant	3,00,000
Interest charges paid to supplier of plant for deferred credit	3,00,000
Estimated dismantling costs to be incurred after 7 years (PV)	4,00,000
Operating losses before commercial production	2,00,000

Advise Rama Ltd. On the costs that can be capitalized in accordance with Ind AS-16.

Question 17

On 1st October 2018, Jadon Ltd. began the construction of a new factory. Costs relating to the factory are as follows :

	` (in thousands)
Purchase of the land	12,000
Cost of dismantling existing structure on the site	50
Purchase of materials to construct the factory	16,000
Employment costs	2,000
Production overheads directly related to the construction	1,500
Allocated general administrative overheads	600
Architects and consultants fees directly related to the construction	700
Costs of relocating staff who are to work at the new factory	300
Costs relating to the formal opening of the factory	400
Interest on loan to partly finance factory construction	1,100
Plant and machinery purchased for use in the factory	5,000

1. The factory took eight months to contract and was brought into use on 30th June 2018. The employment costs are for the nine months to 30th June 2018.
2. The production overheads were incurred in the eight months ended 31st May 2018. They included an abnormal cost ` 2,00,000 caused by the need to rectify damage caused by a gas leak.

3. Jadon Ltd. received the loan of ` 120 lakhs on 1st October 2017. The building meets the definition of a qualifying asset in accordance with Ind AS-23 Borrowing Costs. The loan carries a rate of interest of 10% per annum.

Determine the cost of the asset to be included in the Balance Sheet upon initial recognition, giving reasons for the inclusion or exclusion of costs.

Question 18

On March 31, 2018, Winn Company traded in an old machine having a carrying amount of ` 16,800, and paid cash difference of ` 6,000 for a new machine having a total cash price of ` 20,500. On March 31, 2018, what amount of loss should Winn Company recognize on this exchange?

Question 19

A Plant was depreciated under two different methods as under :

	Straight Line Method	Written Down Value
1st Year	3.90	10.69
2nd Year	3.90	7.90
3rd Year	3.90	5.84
4th Year	3.90	4.32
	15.60	28.75
5th Year	3.90	3.19

Required :

(a) If the company followed WDV for first four years and decides to switch over to SLM, what would be the amount of resultant surplus/deficiency?

(b) If the company followed SLM for first four years and decides to switch over to WDV, what would be amount of resultant surplus/deficiency?

Question 20

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 ` 7,50,000
Construction and remodelling cost of restaurant ` 30,00,000

Explain the treatment of these expenditures as per the provisions of AS 10 "Property, Plant and Equipment".

Answer

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 ` 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 ` 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, ` 7,50,000 should be expensed.

7 AS 11 THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

1. Applicability:

The Accounting Standards is applicable to all enterprises.

2. Scope:

This accounting standard applies to

(a) Transactions entered into in foreign currencies

(b) Translation of financial statement of foreign operations.

(c) Transactions in the nature of forward exchange contracts.

In above cases, the transactions are required to be expressed in the enterprise's reporting currency and the financial statements of foreign operations are required to be translated into the enterprise's reporting currency. To comply with these, following issues are dealt with in this standard:

(a) To decide which exchange rate to use

(b) How to recognise the financial effect of changes in exchange rates.

3. The Accounting Standard does not deal with:

- The presentations in a cash flow statement of cash flows arising from transactions in foreign currency and the transactions of cash flows of foreign operations.
- Re-statement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency.
- Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to interest cost which has been dealt in AS 16.

4. Definitions:

a. Reporting currency:

It is the currency used in presenting the financial statements.

b. Foreign currency:

A currency other than reporting currency.

c. Foreign currency transactions:

Transactions denominated in a foreign currency or where the transaction is settled in foreign currency is called as foreign currency transaction.

Example:

(a) Buying or selling the goods in foreign currency.

(b) Providing or receiving services in foreign currency.

(c) Lending or borrowing in foreign currency.

(d) Acquisition or disposition of assets denominated in foreign currency.

5. Accounting Treatment of Foreign Currency Transactions:

A. Initial recognition of foreign currency transaction:

Whenever a transaction has to be recorded the foreign exchange rate at the date of the transaction has to be applied.

Exception to the above rule is average rate can be applied on the basis of a week or a month if there is no significant fluctuation ill the exchange rate.

B. Valuation at the balance sheet date:

The valuation at the balance sheet date has to be divided into following categories.

a. Monetary items

b. Non-monetary items carried at historical cost

c. Non-monetary items carried at fair value/similar valuation

C. Monetary items:

a. Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amount of money. e.g.: cash, debtors, creditors, loan etc.

b. Monetary items should be converted at closing rate and has to be reported as such. Closing rate is the rate of foreign exchange on the date of balance sheet.

c. If closing rate is unrealistic, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from, or required to disburse, such item at the balance sheet date.

   e.g., when there are restrictions on remittances on balance sheet date.

d. After applying the closing rate as on the date of balance sheet, the difference between the rate applied for initial recognition and closing rate has to be accounted through exchange fluctuations gain or exchange fluctuation loss.

D. Non-monetary items carried at historical cost:

a. Non-monetary items are assets and liabilities other than monetary items. e.g.: fixed assets, inventories and investments in equity shares, etc.

b. Non-monetary items should be continued to be reported at the actual rate used for initial recognition. Thereafter, exchange fluctuation should not be considered.

E. Non-monetary items carried at fair value / similar valuation

The items such as inventory, current investments will come under the category of non-monetary items carried at fair value / similar valuation. These are converted and reported using the exchange rate when such fair value / net realizable value / similar value is determined.

F. Contingent liability

These liabilities are reported at the exchange rate of the balance sheet date.

G. Treatment of exchange difference

All exchange differences should be charged to profit & loss account.

6. Translation of Foreign Operations:

A. Foreign operations:

Operational of the reporting enterprise conducted in a country other than the country of the reporting enterprise. These can be in any of the following forms:

- Foreign subsidiary
- Foreign associate
- Foreign joint venture
- Foreign branch, etc.

B. Categories of foreign operations:

For accounting purposes, the foreign operations have been sub-divided into:

- Integral operation
- Non-integral operation

C. Integral Foreign Operations:

A foreign operation which is carried out as if it was the extension of the activities of the reporting enterprise like dependent branches, sales depot and foreign arm, etc.

D. Translation of financial statements of Integral Foreign Operations:

The individual items in the financial statements of the foreign operation are translated as if all these transactions had been entered into by the reporting enterprise itself. Therefore, the financial statements should be translated by using the principles as prescribed for foreign currency transactions of the reporting entity, as discussed in earlier paragraphs.

E. Non Integral Foreign Operation:

The following are the indications of non- integral foreign operation:

(1) Controlled by reporting enterprises. While the reporting enterprise may control the foreign operation, the activities of foreign operation are carried independently without much dependence on reporting enterprise.

(2) Transactions with the reporting enterprises are not a high proportion of the foreign activities.

F. Translation of financial statements of Non Integral Foreign Operations:

The accounts of non-integral foreign operation are translated using the following principles.

(1) Balance sheet items i.e., assets and liabilities both monetary and non-monetary apply closing rate.

(2) Items of income and expenses at actual exchange rates on the date of transactions. However, average rate is allowed subject to materiality.

(3) Resulting exchange rate difference should be accumulated in a foreign currency translation reserve until the disposal of net investment in non-integral foreign operation.

(4) Contingent liability at closing rate.

7. Disposal of non-integral foreign operation:

When non-integral foreign operation is disposed fully or partly, the corresponding exchange difference lying in the exchange translation reserve is recognized as income or expense.

8. Change in classification from integral to non-integral:

- Translation procedure applicable to non-integral shall be followed from the date of change.
- Exchange difference arising on the translation of non-monetary assets at the date of reclassification is accumulated in foreign currency translation reserve.

9. Change in classification from non-integral to integral:

- Translation procedure as applicable to integral should be applied from the date of change.
- Translated amount of non-monetary items at the date of change is treated as historical cost.

- Exchange difference lying in foreign currency translation reserve is not to be recognized as income or expense till the disposal of the operation even if the foreign operation become integral.

10. Forward Exchange Contract:

A forward contract is an agreement between two parties whereby one party agrees to buy from or sell to the other party as an asset at future date for an agreed price. In case of forward exchange contract the asset is foreign currency.

11. Forward rate:

It is an agreed exchange rate between two parties for exchange of two currencies at a specified future date.

Forward contracts shall be divided into 2 types.

(a) For managing risk (hedging)

(b) For trading and speculation

12. Forward exchange contract entered for managing risk (hedging):

- The forward exchange contract which is primarily entered into with a view to minimize the risk due to fluctuation in the exchange rate on the date of the settlement of the transaction is the contract for managing the risk.
- In forward exchange contract, covered premium may be paid or discount may be earned.
- The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate (spot rate) at the date of inception of the forward exchange contract and forward rate specified in the contract.
- The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract.
- Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change.
- Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

13. Forward exchange contract entered for trading or speculation:

- When the forward exchange contract is entered to earn profit by trading or speculation in foreign exchange, the accounting treatment shall be different as the object is not to reduce the risk but to gain.
- The premium or discount on such forward contract is not to be recognized, in other words, is to be ignored.
- At each balance sheet date the value of contract is marked, to its current market value. Gain or loss on the contract is recognized in the profit & loss account for the period.

14. DISCLOSURE

A. An enterprise should disclose following:

- Amount of exchange difference included in the net profit or loss.
- Amount accumulated in foreign exchange translation reserve, show it as a separate component of shareholders funds
- Reconciliation of opening and closing balance of foreign exchange translation reserve.
- If the reporting currency is different from the currency of the country in which entity is domiciled, the reason for such difference.

B. A change in classification of significant of foreign operation needs following disclosures:

- Nature of change in classification.
- The reason for change.
- Effect of such change on shareholders fund.
- Impact of change in net profit or loss for each prior period presented.

Practical Problems

Question 1

Sunshine Company Limited imported raw materials worth US Dollars 9,000 on 25th February, 2011, when the exchange rate was Rs. 44 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, 2011, when the exchange rate was Rs. 48 per US Dollar. At the yearend 31st March, 2011, the rate of exchange was Rs. 49 per US Dollar.

The Chief Accountant of company passed an entry on 31st March, 2011 adjusting the cost of raw material consumed for the difference between Rs. 48 and Rs. 44 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS 11.

Answer :

The treatment proposed by the Chief Accountant of the company is not correct. AS 11 requires that on each balance sheet date, monetary items needs to be translated at the closing rate. In the present problem, the closing rate is Rs. 49. Thus, the company needs to state its liability at Rs. 4,41,000 (9000 US $ converted @ Rs. 49). What the accountant is proposing is to state the liability at the price at which it has been settled, ie, Rs. 48 per US $. This is not in accordance with the requirements of AS 11 (revised 2003). What the company needs to do is to state the liability at Rs. 4,41,000 on March 31, 2011 and then recognise an exchange gain of Rs. 9,000 (Rs. 1 x 9,000) on the date of actual payment.

Question 2

On 31st March, 2010, the following ledger balances have been extracted from the books of Washington branch office:

Ledger Accounts	$
Building	180
Stock as on 01.04.2009	26
Cash and Bank Balances	57
Purchases	96
Sales	110
Commission receipts	28

Debtors	46
Creditors	65

You are required to convert above Ledger balance into Indian Rupees.

Use the following rates of exchange:

	Rs. Per $
Opening rate	46
Closing rate	50
Average rate	48
For fixed assets	42

Answer :

Conversion of ledger balances (in Dollars) into Rupees.

	Exchange rate to be used for	$	Rate per $	Amount in Rupees
Building	Fixed Assets	180	42	7,560
Stock as on 01.04.2009	Opening	26	46	1,196
Cash and bank balances	Closing	57	50	2,850
Purchases	Average	96	48	4,608
Sales	Average	110	48	5,280
Commission receipts	Average	28	48	1,344
Debtors	Closing	46	50	2,300
Creditors	Closing	65	50	3,250

Question 3

A Ltd. purchased fixed assets costing Rs. 6,000 lakhs on 01.01.2009. This was financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs. 40 and Rs. 45 as on 01.01.2009 and 31.12.2009 respectively. First instalment was paid on 31.12.2009.

You are required to state, how these transactions would be accounted for?

Answer :

Accordingly, the transactions would be recorded as under:

1. Purchase of fixed assets on 01.01.2009:

			Rs. Lakhs
Fixed Assets A/c	Dr.	6,000	
To Foreign Currency Loan A/c			6,000

(Being purchase of fixed asset through foreign currency loan for $ 150 lakhs)

2. On Payment of 1st instalment on 31.12.2009

Foreign Currency Loan A/c	Dr.	2,250	
To Bank A/c			2,250

(Being payment of first instalment of $ 150 lakhs on 31.12.2009)

3. On Charging Exchange Loss to Profit and Loss Account:

Profit & Loss A/c (Foreign exchange loss)	Dr.	250	
To Foreign Currency Loan A/c			250

(Being exchange difference of Rs. 250 lakhs charged to Profit & Loss A/c)

4. For translating the loan on balance sheet date (assuming the accounting year ends on (31.12.2009)

Profit & Loss A/c (Foreign Exchange loss)		500	
To Foreign Currency Loan A/c			500

(Being the foreign currency loan translated at the closing rate)

Working Notes

1. Foreign currency loan $\frac{\text{Rs.6,000 lakhs}}{40}$ = $ 150 lakhs

2. Annual instalment (excluding interest) $ 50 lakhs

3.	Exchange difference at the time of payment of first Instalment (Rs. 45 - 50) x 50 lakhs	Rs. 250 1akhs
4.	Loan outstanding after paying first instalment	$ 100 1akhs
5.	Translation difference on conversion of outstanding Loan (Rs. 45 - 40) x 100 lakhs	Rs. 500 1akhs
6.	In the absence of any information, interest has been ignored.	

Question 4

Goods purchased on 24.02.2008 of US $ 1,000	Rs. 46.60 per US $
Exchange rate on31.03.2008	Rs. 47.00 per US $
Date of actual payment 05.06.2008	Rs. 47.50 per US $

Calculate the loss/gain for the financial year 2007-2008 and 2008-2009 as per AS 11.

Answer :

a. As per AS 11 on The Effects of Changes in Foreign Exchange Rates, a foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

   Thus, goods purchased on 24.02.2008 and corresponding creditors would be Rs. 46,600 ($ 1,000 x 46.6).

b. At balance sheet date all monetary items should be reported using the closing rate, therefore creditors of US $ 1,000 outstanding on 31.03.2008 should be reported. Thus, the amount that should be recorded is Rs. 47,000.

c. Exchange Loss (47,000 - 46,600) = Rs. 400 should be debited in Profit and Loss Account for the year 2007 -2008.

d. Exchange differences on settlement of monetary items should be transferred to Profit and Loss Account as gain or loss, therefore, Rs. 500 [(1 ,000 x 47.50) - 47,000] will be debited to Profit and Loss Account for the year 2008- 2009.

e. The loss that should be recorded is as under:

Financial year	**Loss (Rs.)**
2007-08	500
2008-09	400

Question 5

Beekay Ltd. purchased fixed assets costing ` 5,000 lakh on 01.04.2012 payable in foreign currency (US$) on 05.04.2013. Exchange rate of 1 US$ = ` 50.00 and ` 54.98 as on 01.04.2012 and 31.03.2013 respectively.

The company also obtained a soft loan of US$ 1 lakh on 01.04.2012 payable in three annual equal instalments. First instalment was due on 01.05.2013.

You are required to state, how these transactions would be accounted for in the books of accounts ending 31st March, 2013.

Answer

As per AS 11 (Revised) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as an expense in the period in which they arise. However, Ministry of Corporate Affairs has recently amended AS 11 through a notification. As per the notification, exchange difference 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 requisition of depreciable capital asset, can be added to or deducted from cost of asset. The MCA has given an option for the enterprises to capitalize the exchange differences arising on reporting of long term foreign currency monetary items till 31st March, 2020. Thus the company can capitalize the exchange differences arising due to long term loans linked with the acquisition of fixed assets.

Transaction 1: Calculation of exchange difference on fixed assets

- Foreign Exchange Liability = 5,000 / 50 = US $ 100 lakhs
- Exchange Difference = US $ 100 lakhs x (` 54.98 – ` 50) = ` 498 lakhs.
- Loss due to exchange difference amounting ` 498 lakhs will be capitalised and added in the carrying value of fixed assets. Depreciation on the unamortised amount will be provided in the remaining years

Transaction 2:

- Soft loan exchange difference (US $ 1 lakh i.e ` 50 lakhs)
- Value of loan 31.3.13 → US $ 1 lakh x 54.98 = ` 54,98,000

- AS 11 also provides that in case of liability designated as long-term foreign currency monetary item (having a term of 12 months or more at the time of origination) the exchange difference is to be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) and should be written off over the useful life of such long-term liability, by recognition as income or expenses in each of such periods.
- Exchange difference between reporting currency (INR) and foreign currency (USD) as on 31.03.2013 = US$1.00 lakh X ` (54.98 – 50) = ` 4.98 lakh.
- Loan account is to be increased to 54.98 Iakh and FCMITD account is to be debited by 4.98 lakh. Since loan is repayable in 3 equal annual instalments, ` 4.98 lakh/3 = ` 1.66 lakh is to be charged in Profit and Loss Account for the year ended 31st March, 2013 and balance in FCMITD A/c ` (4.98 lakh – 1.66 lakh) = ` 3.32 lakh is to be shown on the 'Equity & Liabilities' side of the Balance Sheet as a negative figure under the head 'Reserve and Surplus' as a separate line item.

Note: The above answer is given on the basis that the company has availed the option under para 46A of AS 11

Question 6

Mr. Y bought a forward contract for three months of US $ 2,00,000 on 1st December 2010 at 1 US $ = ` 44.10 when the exchange rate was 1 US $ = ` 43.90. On 31-12-2010, when he closed his books, exchange rate was 1 US $ = ` 44.20. On31st January, 2011 he decided to sell the contract at ` 44.30 per Dollar. Show how the profits from the contract will be recognized in the books of Mr. Y.

Answer

As per para 39 of AS 11 'Changes in Foreign Exchange Rates", 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.

	`
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)	` 40,000

Question 7

Stem Ltd. purchased a Plant for US$ 30,000 on 30th November, 2013 payable after 6 months. The company entered into a forward contract for 6 months @ ` 62.15 per dollar. On 30th November, 2013, the exchange rate was ` 60.75 per dollar.

How will you recognise the profit or loss on forward contract in the books of Stem Ltd. for the year ended 31st March, 2014 ?

Answer

A. Calculation of Profit or Loss on forward contract to be recognised in the book of Stem Ltd.

Forward contract rate	` 62.15 per dollar
Less: Spot Rate	` 60.75 per dollar
Loss	` 1.40 per dollar
Forward Contract Amount	US$ 30000
Total Loss on entering into forward contract = US$ 30,000 x ` 1.40=	` 42,000
Contract Period	6 Months

B. Out of total contract period of 6 months, 4 months are falling in the financial year 2013-14.

C. Loss for the period from 1st Dec.2013 to 31st March, 2014= (` 42,000/6) x 4 = ` 28,000.

Thus the loss amounting to ` 28,000 for the period is to be recognised in the year ended 31st March, 2014.

Question 8

Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3.2015.

Sundry Debtors include amount receivable from Umesh ` 5,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $ 1= ` 58.50.

Long term loan taken from a U.S. Company, amounting to ` 60,00,000. It was recorded at US $ 1 = ` 55.60, taking exchange rate prevailing at the date of transaction.

US $ 1 = ` 61.20 on 31.3.2015.

Answer

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or as expenses in the period in which they arise.

However, at the option of an entity, 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 non-depreciable capital asset can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/ liability, by recognition as income or expense in each of such periods.

Question 9

a. ABC Ltd. a Indian Company obtained long term loan from WWW private Ltd., a U.S. company amounting to ` 30,00,000. It was recorded at US $1 = ` 60.00, taking exchange rate prevailing at the date of transaction. The exchange rate on balance sheet date (31.03.2018) was US $1 = ` 62.00.

b. Trade receivable includes amount receivable from Preksha Ltd.,` 10,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = ` 59.00. The exchange rate on balance sheet date (31.03.2018) was US$1 = ` 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.

Answer:

Amount of Exchange difference and its Accounting Treatment

	Long term Loan	Exchange Rate	`
(i)	Initialrecognition ` (30,00,000/60) = US $50,000	1 US $ = ` 60	30,00,000
	Rate on Balance sheet date	1 US $ = ` 62	31,00,000
	Exchange Difference Loss US $ 50,000 x ` (62 – 60)		1,00,000
	Treatment: Credit Loan A/c and Debit FCMITD A/c or Profit and Loss A/c by ` 1,00,000		
	Trade receivables		
(ii)	Initial recognition (`10,00,000/59) = US $16,949.152	1 US $ = ` 59	10,00,000
	Rate on Balance sheet date	1 US $ = ` 62	
	Exchange Difference Gain US $ 16,949.152 x ` (62-59)		50,847.456
	Treatment: Credit Profit and Loss A/c by ` 50,847.456 And Debit Trade Receivables		

Thus, Exchange Difference on Long term loan amounting ` 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` 50,847.456 is required to be transferred to Profit and Loss A/c.

Question 10

AXE Limited purchased fixed assets costing $ 5,00,000 on 1st Jan. 2018 from an American company M/s M&M Limited. The amount was payable after 6 months. The company entered into a forward contract on 1st January 2018 for five months @ ` 62.50 per dollar. The exchange rate per dollar was as follows :

On 1st January, 2018	` 60.75 per dollar
On 31st March, 2018	` 63.00 per dollar

You are required to state how the profit or loss on forward contract would be recognized in the books of AXE Limited for the year ending 2017-18, as per the provisions of AS 11.

Answer:

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", an enterprise may enter into a forward exchange contract to establish the amount of the reporting currency required, the premium or discount arising at the inception of such a forward exchange contract should be amortized as expenses or income over the life of the contract.

Forward Rate	` 62.50
Less: Spot Rate	(`60.75)
Premium on Contract	` 1.75
Contract Amount	US$ 5,00,000
Total Loss (5,00,000 x 1.75)	` 8,75,000

Contract period 5 months and 3 months falling in the year 2017-18; therefore loss to be recognized in 2017-18 (8,75,000/5) x 3 = ` 5,25,000. Rest ` 3,50,000 will be recognized in the following year 2018-19.

8 AS12 ACCOUNTING FOR GOVT. GRANT

1. Applicability:

The Accounting Standard is applicable to all enterprises

2. Definitions:

A. Government:

Government refers to government, government agencies, and similar bodies whether local national or international

B. Government Grants:

Government Grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. Grant includes subsidies, cash incentives, duty drawbacks etc.

3. When to Recognise Government Grant:

Recognise Government Grants when both the following conditions are fulfilled:

(i) It is expected that enterprise will comply with the conditions attached to the grant;

(ii) Expected that the grants will be received

4. How to Recognise Government Grant:

(a) Grants related to Fixed Assets (non-depreciable asset)

- Deduct grant from gross value of asset, or
- Amount of grant may be credited to capital reserve

(However, when grant equals whole or virtually the whole cost of Fixed Asset, then show Fixed Asset at nominal value.)

(b) Grants related to Fixed Assets (depreciable asset)

- Deduct grant from gross value of asset) or
- Amount of grant may be treated as Deferred Income. Recognise in P/L on rational & systematic basis over useful life

(However, when grant equals whole or virtually the whole cost of Fixed Asset, then show Fixed Asset at nominal value.)

(c) Grants related to Revenue

- These are to be recognised in Profit & Loss Account on systematic basis over period to match related costs
- Show under Other Income or Deduct from related expense

(d) Grants in the nature of Promoter Contribution

- These are to be credited to Capital Reserve
- These are treated as a part of shareholders fund

(e) Grants in the form of non-monetary asset given at concessional rate

- Record asset at acquisition cost

(f) Grants in the form of non-monetary asset given free of cost

- Record asset at nominal value

(g) Grants that are receivable as compensation for expenses or losses incurred in previous accounting period or for the purpose of giving immediate financial support with no further related costs

- These should be recognised in Profit & Loss account of the period in which they are receivable.
- Show as Extraordinary item, if appropriate as per AS : 5.

5. Treatment of Refund of Government Grant:

When an entity is unable to fulfill the conditions which were prescribed with granting the grant by the concerned authority then the grant will become refundable. In that condition accounting will be as under;

(a) Related to Revenue

- Reverse the deferred credit, if any. The shortfall should be charged to Profit & Loss Account.

(b) Related to specific Fixed Asset

- Increase Book Value of Asset
- (in this case, depreciation prospectively in residual life), or
- Reduce Capital Reserve, or
- Deferred Income Balance (as appropriate)

(c) In the Nature of Promoter Contribution

- Reduce Capital Reserve

6. Exclusions from Standard:

- Accounting for government grants in financial statements reflecting the effects of changing prices

- Government assistance other than in the form of government grants
- Government participation in the ownership of the enterprise.
-

7. Disclosure:

(a) Accounting Policy

(b) Method of presentation in financial statements

(c) Nature & extent of Govt. Grant recognised in financial statements (including grants of non-monetary assets given at concessional rate / free of cost.)

Practice Problems

Question 1

ABC Limited purchased a machinery for Rs. 25,00,000 which has estimated useful life of 10 years with the salvage value of Rs. 5,00,000. On purchase of the assets Central Government pays a grant for Rs. 5,00,000. Pass the journal entries with narrations in the books of the company for the first year, treating grant as deferred income.

Answer :

This problem is based on AS 12 on "Accounting for Government Grants." When the grant is treated as deferred income, it should be recognised in the profit and loss account in the proportions in which depreciation on such asset is charged. Depreciation is provided on the basis of gross value ie, ignoring the government grant. Accordingly, depreciation will be provided on Rs. 20 lakhs (Rs. 25 lakhs Rs. 5 lakhs, being the estimated residual value). Since the useful life is estimated to be 10 years, the annual depreciation will be Rs. 2 lakhs. An amount of Rs. 50,000 (Rs. 5,000 (Rs. 5,00,000/10) will be recognised as deferred grant in the profit and loss account every year.

Journal entries in the books of ABC Limited for Year 1

Particulars		L.F.	Dr. Amt.	Cr. Amt.
Machinery A/c	Dr.		25,00,000	
To Bank A/c				25,00,000
(Being machinery costing Rs. 25,00,000 purchased)				
Bank A/c	Dr.		5,00,000	
To Deferred Income A/c				5,00,000
(Being receipt of government grant of Rs. 5,00,000 treated as deferred income)				
Deferred income A/c	Dr.		50,000	
To Income from govt. grant A/c				50,000
(Being government grant of Rs. 5,00,000 allocated to income over the period of 10 years and in the proportions in which depreciation on related assets is charged, ie, Rs. 5,00,000/10)				
Income from govt. grant A/c	Dr.		50,000	
To Profit and Loss A/c				50,000
(Being income from government grant transferred to profit and loss account)				

Depreciation A/c	Dr.	2,00,000	
To Accumulated depreciation A/c			2,00,000

(Being depreciation charged on machinery @ Rs. 2,00,000 p.a. [{Rs. 25,00,000-Rs. 5,00,000}/10 years])

Profit and loss A/c	Dr.	2,00,000	
To Depreciation A/c			2,00,000

(Being depreciation transferred to profit and loss account)

Question 2

M.N .P. Company Ltd. purchased a machinery for Rs. 1.00 crore. The State Government granted the company a subsidy of Rs. 40 lakhs to meet partial cost of machinery. The company credited the subsidy received from the State Government to its Profit and Loss Account for the year ended March 31, 2010.

Answer :

As per AS 12 on "Accounting for Government Grants". Accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets.

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

(i) Under the first alternative the grant is shown in the balance sheet as a deduction from the gross value of the assets concerned. The grant is recognized in profit and loss accounts over the useful life of the depreciable life of asset by way of a reduced depreciation charge.

(ii) Under second alternative, it is treated as a deferred income which should be recognised in profit and loss account over useful life of asset in proportion in which depreciation will be charged on the assets concerned. Deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description ie deferred Government Grant.

In the present case, MNP Company Ltd received a subsidy from government worth Rs. 40 lakhs towards meeting partial cost of machinery. The company credited the same to its profit & loss account.

Accounting treatment of grant received towards partial cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant: otherwise it is the duty of the auditor to qualify his report on bringing out the quantification impact clearly.

Question 3

Siva Limited received a grant of Rs. 1,500 lakhs during the last accounting year (2009-10) 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 2010-11, it was found that the conditions or the grant were not complied with and the grand had to be refunded to the Government in full. Elucidate the current accounting treatment with reference to the provisions of AS- 12.

Answer :

This problem is based on AS 12 on "Accounting for Government Grants", As per Para 11 of AS 12, Government Grant may, sometimes, become refundable if certain conditions are not fulfilled. A government grant that becomes refundable is treated as extra-ordinary item as per AS, 5.

The amount refundable in respect of a government grant related to revenue is applied first against any namortised 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 given case, the amount of refund of grant of Rs. 1,500 lakhs should be charged to the profit and loss account in the year2010-2011 as an extraordinary item.

Question 4

Santosh Ltd. has received a grant of Rs. 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed Rs. 2 crores as dividend. Also, Santosh Ltd. received land free of cost from the State Government but it has not recorded it at all in the books as no money has been spent. In the light of AS 12, examine whether the treatment of both the grants is correct.

Answer :

This problem is based on AS 12 'Accounting for Government Grants',

As per AS 12 ‘Accounting for Government Grants’, when government grant is received for a specific purpose, it should be utilised for the same. So the grant received for setting up a factory is not available for distribution of dividend.

In the second case, even if the company has not spent money for the cquisition of land, land should be recorded in the books of accounts at a nominal value. The treatment of both the grants is thus, incorrect.

Question 5

Weak Ltd. acquired the fixed assets of Rs. 100 lakhs on which it received the grant of Rs. 10 lakhs. What will be the cost of the fixed assets as per AS l2 and how it will be disclosed in the Financial Statements.

Answer :

According to AS 12 on ‘Accounting for Government Grants’, grants relating to fixed assets could relate to depreciable as well as non-depreciable fixed asset:

Grants relating to depreciable assets: There are two alternative methods of treatment of such grants.

Alternative I

- Deduct grant from gross value of asset
- Depreciate the asset on net value (ie, gross value less the amount of grant).
- If grant equals the whole or virtually the whole of the cost of the asset then the asset should be recorded at a nominal value.

Alternative II

- Treat the grant as deferred income and recognise it in the profit and loss account in the proportions in which depreciation on such asset is charged.
- Depreciate the asset on the basis of its gross value.

Grants relating to non-depreciable assets: In this case, the accounting treatment depends on the fact whether the grant requires the fulfillment of certain obligations. If yes, then the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income and the deferred income balance should be separately disclosed in the financial statements, otherwise the grant should be credited to capital reserve.

Assuming, in the present case, the grant relates to a depreciable asset and Weak Ltd. adopts alternative I discussed above. In this situation, the fixed assets will be recorded at Rs. 90 lakhs in the balance sheet and depreciation will also be charged on Rs. 90 lakhs. Weak Ltd. should also disclose its accounting policy adopted for government grants, including the methods of presentation.

Question 6

When Government grants are received in the form of assets such as land, plant and equipments, etc., free of cost, then, such assets should be entered in the books of accounts at nominal value. Comment.

Answer :

True, as per AS 12, if the non-monetary assets are given free of cost, then such assets should be recorded at nominal value.

Question 7

A Government grant of Rs. 25 lakhs received 3 years ago in respect of a machinery which costs Rs. 200 lakhs became refundable in March, 2008.

(i) How the receipt of grant would have been recorded in the books of the recipient?

(ii) How the refund of grant would be reflected in the books, at the time of its refund?

Answer :

(i) According to AS 12 on 'Accounting for Government Grants', grants relating to depreciable assets can be treated in the following manner:

Alternative I

- Deduct grant from gross value of asset.
- Depreciate the asset on net value (ie, gross value less the amount of grant).
- If grant equals the whole or virtually the whole of the cost of the asset then the asset should be recorded at a nominal value.

Accordingly, depreciation under this alternative will be charged on Rs. 175 lakhs.

Alternative II

- Treat the grant as deferred income and rcognise it in the profit and loss account in the proportions in which depreciation on such asset is charged.

- Depreciate the asset on the basis of its gross value.

(ii) As per Para 21 of AS 12, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, ie, where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

Question 8

The Central Government sanctioned Rs. 20 lakh as Grant to a Hospital for the purchase of certain equipments and paid Rs. 10 lakh as advance. The hospital took Rs. 10 lakh as income in the Profit and Loss account for the year.

Answer :

The treatment adopted by the Hospital is incorrect. According to AS 12 on 'Accounting for Government Grants'. grants relating to depreciable assets can be treated in the following manner

Alternative I

- Deduct grant from gross value of asset
- Depreciate the asset on net value (ie. gross value less the amount of grant)
- If grant equals the whole or virtually the whole of the cost of the asset then the asset should be recorded at a nominal value.

Alternative II

- Treat the grant as deferred Income and recognise it In the profit and loss account in the proportions In which depreciation on wuch asset is charged.
- Depreciate the asset on the basis of its gross value

Thus, the Hospital cannot recognise Rs. 10 lakhs as income in the Profit and Loss Account for the year. It can, at best, treat the grant as deferred income and recognise it in the profit and loss account in the proportion in which depreciation on such asset is charged.

Question 9

(a) Wye Ltd. received Rs. 50 lacs from the Central Govt. as subsidy for setting-up an industry in backward area. How will you treat it in accounts?

(b) How Govt. grants relating to Specific Fixed Assets is treated in the books as per AS-12?

Answer :

Accounting for government grants should be based on the nature of the grants. Grants which have the characteristics similar to those of promoters' contribution (ie, which are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected) should be accounted for on the basis of 'Capital Approach', whereas other grants (ie, grants related to revenue) should be accounted for on the basis of 'Income Approach'.

Accordingly :

(a) Rs. 50 lacs received from the Central Govt. as subsidy for setting up an industry in backward area should be treated as grant in the nature of promoter's contribution and hence, should be credited to capital reserve. It can neither be distributed as dividend nor considered as deferred income.

(b) Grants relating to depreciable assets can be treated in the following manner.

Alternative I

- Deduct grant from gross value of asset.
- Depreciate the asset on net value (ie, gross value less the amount of grant)
- If grant equals the whole or virtually the whole of the cost of the asset then the asset should be recorded at a nominal value.

Alternative II

- Treat the grant as deferred income and recognise it in the profit and loss account in the proportions in which depreciation on such asset is charged.
- Depreciate the asset on the basis of its gross value.

Question 10

X Ltd. Acquired a fixed asset for Rs. 50,00,000. The estimated useful life of the asset is 5 years. The salvage value after useful life was estimated at Rs. 5,00,000. The State Government gave a grant of Rs. 10,00,000 to encourage the asset acquisition. At the end of the second year, the subsidy of the State Government became refundable. What is the fixed asset value after refund

of grant/subsidy to the State Government but before amortising the asset value at the end of the second year?

Answer :

Value of fixed assets at the end of the second year :

	Rs.
Original cost of fixed assets	50,00,000
Less : Government grant received	(10,00,000)
Less : Amount to be depreciated in the first year $\frac{4000000 - 500000}{5 \text{ years}}$	(7,00,000)
Add : Refund of State Government grant	33,00,000
Value of fixed assets at the end of the second year after refund of grant but before depreciation	43,00,000

Question 11

How would you record a non-monetary grant received frorn the Government as per AS 12?

Answer :

(i) If a government grant is given in the form of non-monetary assets such as land or other resources given at concessional rates. then such assets should be recorded at their acquisition cost.

(ii) If the non-monetary assets are given free of cost, then such assets should be recorded at nominal value

Question 12

How refund of revenue grant received from the Government is disclosed in the Financial Statements?

Answer :

A Government grant relating to revenue may have to be refunded if certain conditions attached to it have not been fulfilled. In such a case, the following treatment should be adopted while making the disclosures in the financial statements:

1. The amount to be refunded should be applied first against any unamortized 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 should be charged to the profit and loss account of the year in which the Government grant has become refundable. The amount refunable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, ie, where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

2. Such refunds should be accounted for and disclosed as an extraordinary item. (AS 5 provides that 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.

Question 13

On 01.04.2001 ABC Ltd. received Government grant of Rs. 300 lakhs for acquisition of a machinery costing Rs. 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 2004 due to non-fulfilment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd.?

Answer :

ABC Ltd. is required to refund the grant in May 2004 due to non-fulfilment of certain conditions. According to AS 12 on 'Accounting for Government Grants', government grants that become refundable should be accounted for as an extraordinary item. Further, since the grant was credited to the cost of the asset, the amount refundable (ie Rs. 300 lakhs) should be added to the book value of the asset. Depreciation on the revised book value should be provided prospectively over the remaining useful life of the asset.

The relevant calculations are shown below :

	Rs. lakhs
Cost of machinery on 01.04.2001	1,500.00
Less : Government grant	300.00
Book value of machinery on 01.04.2001	1,200.00

Depreciation for 2001-02 @ 20%	240.00
WDV on 01.04.2002	960.00
Depreciation for 2002-03 @ 20%	192.00
WDV on 01.04.2003	768.00
Depreciation for 2003-04 @ 20%	153.60
WDV on 01.04.2004	614.40
Add : Amount of grant refunded	300.00
Revised Book value	914.40
Depreciation for 2004-05 @ 20% on the revised book value	182.88
WDV as on 01.04.2005	731.52

Question 14

X Limited received a grant of Rs. 2 crores from the Central Government for the purpose of a special Machinery during 1998-89. The cost of Machinery was Rs. 20 crores and had a useful life of 9 years. During 2002-03, the grant has become refundable due to non- fulfilment of certain conditions attached to it. Assuming the entire grant was deducted from the cost of Machinery in the year of the entire grant was deducted from the cost of Machinery in the year of acquisitions, state with reasons, the accounting treatment to be followed in the year 2002-03.

Answer :

The present situation is based on AS 12 on 'Accounting for Government Grants'. AS 12 requires that the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset. Depreciation on the revised book value should be provided PROSPECTIVELY over the remaining useful rife of the asset. Accordingly, the grant of Rs. 2 crores which was earlier deducted from the cost of machinery will now be added back. The relevant calculations are shown below:

	Rs.
Gross Book Value in 1998-99	Rs. 20crores
Net Book Value in 1998-99 (Rs. 20 crores - Rs. 2 crores)	18 crores
Annual depreciation (assuming SLM and no scrap value)	2 crores
Depreciation provided till 2001-02	8 crores

Net Book value during 2002-03	10 crores
Amount of grant refundable	2 crores
Revised book value	12 crores
Remaining useful life	5 years

Revised annual depreciation = $\frac{\text{Revised book value}}{\text{Remaining useful life}}$

= $\frac{\text{Rs.12 crores}}{5}$ =

Depreciation for the year 2002-03Rs. 2.4 crores

Amount of Government grant that has become refundable should be accounted for as an extraordinary item and disclosed appropriately as per AS 5.

Question 15

V Lid received revenue grant from the State Government of Bihar amounting to Rs. 5 crores during the accounting period 2001-02. The grant was given subject to certain conditions to be fulfilled by the company. During the accounting period 2002-03, the entire amount became refundable as the conditions attached to it could not be fulfilled The company has so far recognised Rs. 1 crore in the profit and loss account of the year 2001-02. The accountant of the company wants to charge Rs. 5 crores, being the amount of refund over the period of 5 years.

Answer:

Refund to be treated as an extraordinary item as per Para 20 of AS 12. First adjust the refund amount against the unamortized deferred credit of Rs. 4 crores remaining in respect of the grant. Balance of Rs. 1 crore to be charged to profit and loss account of the year 2002-03 as an extraordinary item.

Question 16

X Ltd. acquired a machine on 01.01.2004 for Rs. 20,00,000. The useful life is 5 years. The company had applied on 01.04.2004 for a subsidy to the tune of 75% of the cost. The sanction letter for subsidy was received in November 2007. The company's Fixed Assets Account as at 31.03.2008 shows a credit balance as under:

Machine (original cost)	20,00,000
Accumulated depreciation	

(from 2004-2005 to 2006-2007 at straight line method)	(12,00,000)
	8,00,000
Less: Grant received	(15,00,000)
	(7,00,000)

How should the company deal with this asset in its account for 2007 -08? Does it need to charge depreciation or negative depreciation for 2007 -08? Can it credit Rs. 7,00,000 to capital reserve?

Answer:

In case of depreciable assets, there are two options for treating government grants:

(i) Reduce the grant from the cost of fixed assets; or

(ii) Treat the grant as deferred income.

In the present case, X Ltd. seems to be following the first option. Thus, it should treat the grant in the following manner:

(a) Credit Rs. 8,00,000 to Machinery account being the balance left in Machinery account.

(b) Credit Rs. 7,00,000 to Profit & Loss Account as a partial recovery of Rs. 12,00,000 of depreciation already charged to profit and loss account in the earlier years.

Further, the company need not charge any depreciation for 2007-08 as the depreciable amount has already been reduced to Nil. Amount of Rs. 7,00,000 cannot be credited to capital reserve as well.

Question 17

Viva Ltd. received a specific grant of ` 30 lakhs for acquiring the plant of ` 150 lakhs during 2007-08 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet. During 2010-11, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the Government. Balance in the deferred income on that date was ` 21 lakhs and written down value of plant was ` 105 lakhs.

(a) What should be the treatment of the refund of the grant and the effect on cost of the fixed asset and the amount of depreciation to be charged during the year 2010-11 in profit and loss account?

(b) What should be the treatment of the refund, if grant was deducted from the cost of the plant during 2007-08 assuming plant account showed the balance of ` 84 lakhs as on 1.4.2010?

Answer

As per para 21 of AS-12, 'Accounting for Government Grants', "the amount refundable in respect of a grant related to specific fixed asset should be recorded by reducing the deferred income balance. To the extent the amount refundable exceeds any such deferred credit, the amount should be charged to profit and loss statement.

(a) In this case the grant refunded is ` 30 lakhs and balance in deferred income is ` 21 lakhs, ` 9 lakhs shall be charged to the profit and loss account for the year 2010-11. There will be no effect on the cost of the fixed asset and depreciation charged will be on the same basis as charged in the earlier years.

(b) If the grant was deducted from the cost of the plant in the year 2007-08 then, para 21 of AS-12 states that the amount refundable in respect of grant which relates to specific fixed assets should be recorded by increasing the book value of the assets, by the amount refundable. Where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. Therefore, in this case, the book value of the plant shall be increased by ` 30 lakhs. The increased cost of ` 30 lakhs of the plant should be amortized over 7 years (residual life).

(c) Depreciation charged during the year 2010-11 shall be (84 + 30)/7 years = ` 16.286 lakhs presuming the depreciation is charged on SLM.

9 AS 1 6BORROWING COST

1. Applicability:

The Standard is applicable to all enterprises

2. Meaning of Borrowing Cost:

The Borrowing Costs are Interest and other costs incurred in connection with borrowing of funds. It includes the following expenses:

- Interest,
- Commitment charges
- Amortization of discount or premium
- Amortization of ancillary cost
- Exchange differences to the extent these are regarded as an adjustment of interest costs, etc.

Note :

Cost of equity capital or preference capital, whether actual or imputed is not considered as Borrowing Cost.

3. Meaning of Qualifying Asset

Qualifying Asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. For example if a manufacturing plant or inventory of goods or investment property takes a substantial period of time to get ready for use or sale then that will be treated as a qualifying asset.

Thus, the assets which are ready for their intended use or sale when acquired are not qualifying assets. For example if we purchase a truck then it immediately ready for use therefore it will never be treated as a qualifying asset.

Here substantial period of time means a period of 12 months. As per AS 16 the substantial period can be taken to be more than or less than 12 months depending upon the facts and circumstances of the situation.

4. Recognition of Borrowing Cost:

(a) Borrowing costs should be capitalized as a part of cost of the asset if it is directly attributable to:

- Acquisition,
- Construction or

- Production of qualifying asset

(b) Other borrowing cost are considered as expense in the period in which these are incurred.

5. How to Recognise Borrowing Cost:

A. In case of Specific borrowings:

Specific borrowing means a borrowing which has been taken to purchase a particular specific asset. Actual borrowing cost of funds specifically borrowed for a particular qualifying asset is directly capitalized in the cost of the asset. Income from temporary investment out of specific borrowed funds to be deducted from borrowing cost.

B. In case of General borrowings:

(i) In case single borrowing is used for few qualifying assets then such borrowing is called general borrowing.

(ii) If the amount of general borrowing is used in the asset in parts then in that condition we will calculate a weighted average amount of funds invested in the asset during the year and then borrowing cost will be charged on this average amount of investment.

(iii) If there are more than one type of general borrowing then we will calculate average rate of borrowing cost on overall amount of general borrowings and borrowing cost to be capitalized in the cost of the qualifying asset will be calculated at this average rate of borrowing cost.

6. When to Recognise:

A. Commencement of Capitalisation

Capitalisation of Borrowing costs should commence when all the following conditions are fulfilled

(a) Expenses are being incurred on acquisition or construction or production of qualifying assets;

(b) Borrowing costs are being incurred;

(c) Activities, which are essential for construction or acquisition are in progress for assets intended use or sale of qualitying asset.

Notes:

(a) The expenditure incurred on qualifying asset includes only following

- Cash payments, or
- Transfer of assets, or

- Assumption of interest bearing liabilities

(b) The expenditure on asset means actual carrying amount of asset plus borrowing cost previously capitalized.

B. Suspension of Capitalisation:

(a) Capitalization of borrowing costs should be suspended during extended periods when active development on qualifying asset is interrupted.

(b) Capitalisation of borrowing costs is not suspended if the delay is a necessary part of the process of getting an asset ready for its intended use or sale.

C. Cessation of Capitalisation:

Capitalisation of borrowing costs should cease when substantially all activities for qualifying asset intended use or sale are complete. Even in case of completion of 'Independent Portion' capitalization on such portion should cease.

7. Disclosure :

Following are required to be disclosed

A. Accounting Policy tor Borrowing costs

B. Amount of borrowing cost capitalised during the period

EXAMINATION PROBLEMS

Question 1

On 1st April, 2009, Amazing Construction Ltd. obtained a loan of Rs. 32 crores to be utilized as under

(i)	Construction of sea link across two cines (work was held up for a month during the year due to high water levels)	Rs. 25 crores
(ii)	Purchase of equipments and machineries	Rs. 3 crores
(iii)	Working capital	Rs. 2 crores
(iv)	Purchase of vehicles	Rs. 50,00,000
(v)	Advance for tools/cranes etc.	Rs. 50,00,000
(vi)	Purchase of technical know-how	Rs. 1 crores
(vii)	Total interest charged by the bank for the year ending 31st March. 2010	Rs. 80,00,000

Show the Treatment of interest by Amazing Construction Ltd.

Answer :

This problem is based on AS 16 on "Borrowing Costs". According to the Standard, qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use.

The Standard provides that borrowing costs that are directly attributable to the acquisition, construction of production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The treatment of interest by Amazing Construction Ltd is shown as under:

Particulars	Qualifying Asset	Interest to be Capitalised (`)	Interest to be charged to Profit & Loss A/c (`)
Construction of sea-link	Yes	(80,00,000X 25/32) = 62,50,000	
Purchase of equipments and machineries	No	---	(80,00,000X3/32) = 7,50,000
Working capital	No	---	(80,00,000X2/32) = 5,00,000
Purchase of vehicles	No	---	(80,00,000X 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
Total		**62,50,000**	**17,50,000**

Question 2

Rohini Limited has obtained loan from an Institution for Rs. 500 lacs for modernization and renovation of its plant and machinery. The installation of plant and machinery was completed on 31.03.2009 amounting to Rs. 320 lacs and Rs. 50 lacs was advanced to suppliers of additional assets and the balance of Rs. 130 lacs has been utilised for working capital requirements. Total interest paid for the above loan amounted to Rs. 65 lacs during 2008-09. You are required to state how the interest on institutional loan is to be accounted for in the year 2008-09.

Answer :

As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets should be capitalised as part of the costs of those assets. Other borrowing costs are recognised as expense in the period in which they are incurred. A qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use or sale.

The treatment for total interest amount of Rs. 65 lakhs can be given as:

Purpose	Nature	Interest to be capitalized (Rs. in lakhs)		Interest to be charged to Profit and Loss A/c (Rs. in lakhs)	
Installation of Plant and Machinery	Qualifying asset	$\frac{65}{500}$ =	41.60		
Advance to suppliers for additional assets	Qualifying asset	50 x $\frac{65}{500}$ =	6.50		
Working Capital	Not a qualifying asset			130 x $\frac{65}{500}$ =	16.90

			48.10		16.90

Question 3

An industry borrowed Rs. 40,00,000 for purchase of machinery on 01.06.2007. Interest on loan is 9% per annum. The machinery was put to use from 01.01.2008. Pass journal entry for the year ended 31.03.2008 to record the borrowing cost of loan as per AS 16.

Answer :

Computation of interest to be capitalised Rs.

	Rs.
Interest upto 31.03.2008	
(40,00,000 x 9 x 10/12)	3,00,000
Less: Interest relating to pre-operative period for 01.06.2007 to 31.12.2007	
(3,00,000 x 7/10)	2,10,000
Amount to be charged to Profit & Loss A/c	**90,000**

Journal Entries

1.	When total interest is due:		
	Interest on Loan A/c	Dr.	3,00,000
	To Loan A/c		3,00,000
2.	When interest is capitalised:		
	Machinery A/c	Dr.	2,10,000
	To Interest on Loan A/c		2,10,000
3.	For transferring interest expense to Profit or Loss :		
	Profit & Loss A/c	Dr.	90,000
	To Interest on Loan A/c		90,000

Question 4

A Ltd. is a holding company of B Ltd. B Ltd. is going to start a new project, estimated to cost Rs. 20 crores. For this A Ltd. made an Investment of Rs. 10 crores in the shares of B Ltd. by borrowing the same from financial institution @ 10% p.a. As on 31st March, 2005 the project

was not completed. The Director of A Ltd. want to capitalize the interest up to 31st March, 2005 on borrowings amounting to Rs. 1 crore and add it to the cost of investments. Comment.

Answer :

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 the asset.

Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, for example, manufacturing plants, power generation facilities etc. that require a substantial period of time to bring them to a saleable condition.

In the given case, Interest must not be capitalised because investment in the shares of subsidiary company is not a qualifying asset.

The auditor should bring this to the knowledge of management and interest of Rs. 1 crore should be shown as an expenditure in Profit & Loss A/c.

Question 5

As a company auditor how would you react to the following situation:

Interest on loan borrowed to purchase a machinery which has been installed two years back is still debited to machinery account.

Answer :

In the present case, we as an auditor, will qualify the audit report. This situation is based on AS 16 on 'Borrowing Costs', issued by ICAI. AS 16 allows capitalization of borrowing costs subject to fulfillment of certain conditions such as costs should be directly attributable to the acquisition, construction or production of a 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. Having regard to this, in the present case, interest should not be debited to machinery account as this would be overstatement of value of machinery and profits.

Hence, the need for qualification of the audit report along with the quantitative impact on the assets and profit.

Question 1

State whether the following accounting policy on borrowing costs adopted by various companies are in consonance with AS 16:

(i) Borrowing cost is charged to profit and loss account except the cost of borrowing for acquisition of qualifying asset which is capitalised till the date of commercial use of the asset.

(ii) Borrowing cost directly attributable to the acquisition, construction or production of qualifying assets are capitalised till the asset is ready for use as part of the cost of the asset. Interest on working capital is charged to revenue.

(iii) Interest on loans taken to meet the cost of holding of spirit up to maturity has been included in the value of stock as at the balance sheet date (The company is engaged in manufacture of liquor).

Answer: (i) Correct (ii) Correct (iii) Correct, if maturity period of liquor exceeds one year.

Question 6

The expenses incurred by NTPC Ltd. in three phases of a period relating to construction of a thermal power plant are as under:

(Amounts in Rs. crores)

Phase	I	II	III
Cash payments	70	75	80
Transfer of assets	75	30	40
Amount borrowed @ 10% p.a.			Rs. 300 crores

Phase I is completed by 31.03.2003 (end of accounting year 2002-03). What amount of borrowing costs should be capitalised by the company?

Answer: Rs. 18.2432 crores (Phase II Rs. 8.5135 crores, Phase III Rs. 9.7297 crores)

Borrowed funds and interest thereon to be allocated in the ratio of expenditure incurred in various phases.

Question 7

As an auditor state your views on the following accounting policy of All Right Ltd.: An amount of Rs. 50 crores was borrowed @ 12% p.a. on 01.01.2002 for construction of plant. The plant is likely to take three years for its completion. The weighted average cost of capital being 14%, an amount of Rs. 7 crores has been capitalised for the accounting period ending on 31.12.2002.

An income of Rs. 1 crore derived from temporary parking of surplus funds (out of Rs. 50 crores has been credited to Profit and Loss Account.

Answer: Treatment is incorrect. Borrowing cost to be capitalised Rs. 5 crores. (Rs. 6 crores - Rs. 1 crore)

Question 8

RGS Ltd. has raised a loan of $ 50,000 on 01.04.2004 for a specific project @ 2% p.a. payable annually. On 01.04.2004 the exchange rate is Rs. 48 per $. On 31.03.2005, the exchange rate is Rs. 50 per $. The corresponding amount could have been borrowed by RGS Ltd. in Indian currency @ 10% p.a. as on 01.04.2003. Compute the amount that could be included in borrowing costs.

Answer: Entire amount of Rs. 1,48,000 (Rs. 48,000 + Rs. 1,00,000) should be included in borrowing costs.

Question 9

In May, 2004 Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2005 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 Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2005 amounted to 25 lakhs.

Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalised on the plea that the loan was specifically taken for the construction of factory building?

Answer: No, Rs. 25 lakhs cannot be treated as part of the cost of the factory building. Para 19 of AS 16 on 'Borrowing Costs' provides that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Hence, what can be capitalised out of Rs. 25 lakhs is only Rs. 18 lakhs, ie, the interest puto the period when the construction was completed (January 2005). For deciding the period upto which interest is to be capitalised, it does not matter whether the funds have been borrowed generally or specifically for the purpose of obtaining a qualifying asset.

Question 10

Axe Limited began construction of a new plant on 1st April, 2011 and obtained a special loan of ` 4,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.

The expenditure that were made on the project of plant were as follows:

	`
1st April, 2011	5,00,000
1st August, 2011	12,00,000
1st January, 2012	2,00,000

The company's other outstanding non-specific loan was ` 23,00,000 at an interest rate of 12%. The construction of the plant completed on 31st March, 2012. You are required to:

Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".

Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.

Answer

A. Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

	`
Cost of Plant (5,00,000 + 12,00,000 + 2,00,000)	19,00,000
Add: Amount of interest to be capitalised (W.N.2)	1,54,000
	20,54,000

B. Journal Entry

		`	`
31.3.12	Plant A/c Dr.	20,54,000	
	To Bank A/c		20,54,000
	[Being amount of cost of plant and borrowing cost thereon capitalised]		

Working Notes:

1. Computation of average accumulated annual borrowing:

		`
1st April, 2011	` 5,00,000 X 12/12	5,00,000
1st August, 2011	` 12,00,000 X 8/12	8,00,000
1st January, 2012	` 2,00,000 X 3/12	50,000
	Annual Average Borrowing	13,50,000

2. Calculation of interest to be capitalised:

	`
On specific borrowing (` 4,00,000 x10%)	40,000
On non-specific borrowings (` 13,50,000 – ` 4,00,000) = 9,50,000 × 12%	1,14,000
Amount of interest to be capitalized	1,54,000

Question 11

M/s. Ayush Ltd. began construction of a new building on 1st January, 2014. It obtained ` 3 lakh special loan to finance the construction of the building on 1st January, 2014 at an interest rate of 12% p.a. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
` 6,00,000	11% p.a.
` 11,00,000	13% p.a.

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

	Amount (`)
January, 2014	3,00,000
April, 2014	3,50,000
July, 2014	5,50,000
December, 2014	1,50,000

Building was completed on 31st December, 2014. Following the principles prescribed in AS 16 ‘Borrowing Cost’, calculate the amount of interest to be capitalized and pass one Journal entry for capitalizing the cost and borrowing in respect of the building.

Answer

Borrowing cost to be capitalised is ` 103595

Question 12

Shan Builders Limited has borrowed a sum of US $ 10,00,000 at the beginning of Financial Year 2014-15 for its residential project at LIBOR + 3 %. The interest is payable at the end of the Financial Year. At the time of availment, exchange rate was ` 56 per US $ and the rate as on 31st March, 2015 ` 62 per US $. If Shan Builders Limited borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2015 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

Answer

a. Interest for the period 2014-15

= US $ 10 lakhs x 4% × ` 62 per US $ = ` 24.80 lakhs

b. Increase in the liability towards the principal amount

= US $ 10 lakhs × ` (62 - 56) = ` 60 lakhs

c. Interest that would have resulted if the loan was taken in Indian currency

= US $ 10 lakhs × ` 56 x 10.5% = ` 58.80 lakhs

d. Difference between interest on local currency borrowing and foreign currency borrowing

= ` 58.80 lakhs - ` 24.80 lakhs = ` 34 lakhs.

Therefore, out of ` 60 lakhs increase in the liability towards principal amount, only ` 34 lakhs will be considered as the borrowing cost. Thus, total borrowing cost would be ` 58.80 lakhs being the aggregate of interest of ` 24.80 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 ` 34 lakhs.

Hence, ` 58.80 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 “Borrowing Costs” and the remaining ` 26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11 “The Effects of Changes in Foreign Exchange Rates”.

10 AS 17 SEGMENT REPORTING

1. **It is mandatory for level I entities and Non SMC.**
2. **Scope of AS 17**

   This Standard should be applied in presenting general purpose financial statements.

   a. The requirements of this Standard are also applicable in case of consolidated financial statements.

   b. An enterprise should comply with the requirements of this Standard fully and not selectively.

   c. If a single financial report contains both consolidated financial statements and the sparate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements.
3. **Meaning of Segments**

   Standard requires disclosure relating to business segment and geographical segment. These are defined as below :

   a. Business Segment

      i. It means component of business which is involved in production of goods or rendering of services and having separate risk and return in comparison to other segments.

      ii. Such segment can be based on :

         (a) Nature of product and services, (Cement, Steel, Paper)

         (b) Type or class of customer, (Institutional vs. Retail)

         (c) Nature of production process, (Automated, Manual)

         (d) Method used to distribute product or services, (Branch vs. Franchise)

         (e) Nature of the regulatory environment, (Banking, Insurance).

   b. Geographical Segment

      i. It is component of business based on area of operation having separate risk and return.

      ii. Such segment can be based on :

(a) Similarity of economic and political condition, (Democracy vs. Military Rule)

(b) Relationship between Operation in different geographical area, [Operation in France and Germany (virtually the same economic environment)]

(c) Underlying currency risk, (Euro vs. Dollar)

(d) Exchange control regulations, (Partial vs. Fully Convertible Currency)

(e) Special risk associated with the operation in particular area, (Backward vs. Forward).

Note : Geographical Segment is based on:

(a) Location of asset

(b) Location of customers.

4. Identifying Primary and Secondary Segments

Primary and Secondary segment shall be determined by the dominant source and nature of risk and return of an enterprise. If dominant risk and return is due to product and services them Business Segment is primary. If dominant risk and return is effected by geographical area the primary segment is geographical segments. Primary and Secondary segment can be more clearly analysed by following table.

Dominant	**Primary**	**Secondary**
Product and Services	Business	Geographical
Geographical Area	Geographical	Business
Both	Business & Geographical	Requires Matrix Presentation
Not available	Business (assumed)	Geographical

Note : It is important to identify primary and secondary segment because disclosure requirement is different.

5. Determining Reportable Segment

(a) By Qualifying Limits

(i) Revenue Tax :

Segment Revenue 10% or more of total segment revenue segment is reportable segment. [Sale both internal and external considered].

(ii) Result Test :

The absolute amount of reported profit/loss is 10% or more of the greater, in absolute amount of:

- The combined reported profit of all the operating segment that did not report a loss, and
- The combined reported loss of all the reporting segments that reported a loss.

(iii) Assets Test :

Assets are 10% or more of the combined assets of all segments.

(b) Management Choice

Although segment does not fulfil the criteria of Method 1 but management wants to report it then it become a reportable segments.

(c) The 75% Test

If the combined external sales of tall the segments is loss than 75% of the total enterprise external sales then more segments are added until condition, 75% is met.

(d) Previous year Base

If a segment is reportable in previous year by Method 1 but not in Current Year then it should be reported in current year.

(e) Rule to be applied except for Method 2 and Method 3

Particulars	P Y	C Y	Treatment in Current year	Treatment in Next Year
(i) Reportable in the basis of Method 1	✓	✗	Continue as reportable in	Ceases to be reported current year
(ii) Reportable in the basis of Method 1	✗	✓	Restate previous year information	Report

6. Terms Defined

(a) Segment Revenue :

It means revenue of particular segment

Includes	Excludes
• Direct revenue • Inter-segment income • Allocated income.	• Extraordinary Item • Interest/dividend income except they represent financial segment • Gain on sale of investment or redemption of liability except segment information is financial in nature.

(b) Segment expenses :

It represents expense of particular segment

Includes	Excludes
• Expenses directly attributable. • Expenses on transaction with other segment. • Allocated expenses.	• Extraordinary Item • Interest including interest on loan from other segment unless segment information are of financial nature. **Ex. :** Tax and Corporate Level expenses.

(c) Segment Assets :

Those assets that are employed by a segment in its operating activities and which are either directly attributable or can be allocated on reasonable basis.

Includes	Excludes
• Operating assets directly attributable. • Operating assets allocated on reasonable basis. • Includes goodwill if that can be directly attributable to a segment, or if it can be attributed on reasonable basis.	• Income tax assets i.e. advance tax. • Corporate assets

Note : Segment assets are to be considered at amount net of provision or allowances.

Ex. : Fixed assets less depreciation, debtor less provision etc.

(d) Segment Liabilities :

Those operating liabilities that result from the operating activities of a segment.

Includes	Excludes
• Arising out of operation directly attributable to the segment. • Arising from operation allocated on a reasonable basis to segment.	• Provision for tax. • Corporate level borrowing.

7. Primary Disclosure

Primary Segment Information to be disclosed by the entity (7 points)

a. Segment Revenue with external and external sales

b. Segment Result

c. Segment Assets

d. Capital expenditure i.e. expenditure on purchase of fixed assets during year

e. Segment Liability

f. Depreciation on segment fixed assets

g. Non-cash expenses except depreciation in case of fixed assets

Note : Disclosure of segment depreciation and non-cash item is not required if the entity prepare cash flow of the segment.

8. Secondary Segment Disclosure:

The following information will be disclosed by the entity regarding secondary segment:

a. Segment Revenue with external and internal sales

b. Segment Assets

c. Capital expenditure i.e. expenditure on purchase of fixed assets during year

Format of Primary Reporting

	A	B	C	Inter-Segment Elimination	Total
Segment Revenue					
External Sales	xxx	xxx	xxx		
Internal Sale	xxx	xxx	xxx	(xxx)	xxx
Total	xxx	xxx	xxx		xxx
Segment Result	xxx	xxx	xxx	xxx	xxx
(+) Interest and dividend income					xxx
(±) Extra ordinary item					xxx
(-) Interest Exp.					xxx
(-) Administration Exp.					xxx
(-) Tax+					xxx
Profit after Tax					xxx
Segment Assets					
Fixed Assets	xxx	xxx	xxx		xxx
Working Capital	xxx	xxx	xxx		xxx
					xxx
(+) Unallocated Assets					xxx
Enterprises Assets					xxx
Segment Liabilities	xxx	xxx	xxx		xxx
(+) Unallocated Liabilities					xxx
Enterprises Liabilities					xxx
Capital Expenditure	xxx	xxx	xxx		xxx
Depreciation	xxx	xxx	xxx		xxx
Non-cash expenditure	xxx	xxx	xxx		xxx

Practical Problems

Question 1

The Chief Accountant of Sports Ltd., gives the following Data regarding its six segments.

` in lakhs

Particulars	M	N	O	P	Q	R	Total
Segment Assets	40	80	30	20	20	10	200
Segment Results	50	-190	10	10	-10	30	-100
Segment Revenue	300	620	80	60	80	60	1,200

The Chief Accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

Question 2

An enterprise produces the following products and market in two geographic segments. It considers product differentiation as the major element of risk and return. Given below is relevant information for size test

(` in lakhs)

Products	P1	P2	P3	P4	P5	Total
External Sales	150	40	25	50	28	293
Assets	300	50	50	70	40	510
Profit	50	-20	-6	10	5	39
Total of Profit						65
Total of Loss						26

Indentify Reportable Segments.

Question 3

Mohini Ltd. has 2 Segments namely X, Y, Z. The Total Assets of the Company are ` 10.00 Crores. Segment X has ` 2 Crores, Segment Y has ` 3 Crores and Segment Z has ` 5 Crores.

Deferred Tax Assets included in the Assets of each Segment are X - ` 0.50 Crores, Y - ` 0.40 Crores and Z - ` 0.30 Crores. The Accountant contends that at the three Segments are Reportable Segments. Comment.

Question 4

Induga Ltd. has three divisions A, B and C. Details of their turnover, results and net assets are given below :

Rs. ('000)

Division A	
Sales to B	3,050
Other Sales (Home)	60
Export Sales	4,090
	7,200
Division B	
Sales to C	30
Export Sales to Europe	200
	230
Division C	
Export Sales to America	180

	Head Office	Divisions		
		A	**B**	**C**
Operating Profit or Loss before Tax		160	20	(8)
Re-allocated cost from Head Office		48	24	24
Interest Costs		4	5	1

Fixed Assets	50	200	40	120
Net Current Assets	48	120	40	90
Long-term liabilities	38	20	10	120

Prepare a Segment Report for publication in Induga Ltd.

Question 5

Indentify the reportable segment by profitability test is demonstrated as follows for XYZ Ltd.

Segment	Profit (Loss)
A	450
B	50
C	(350)
D	(40)
E	(210)

Answer :

First, the operating segments are grouped according to whether they incurred a profit or loss, as follows :

Segments Incurring Profits		Segments Incurring Losses	
Segment	**Profit (`)**	**Segment**	**Loss (`)**
A	450	C	(350)
B	50	D	(40)
	--	E	(210)
	500		**600**

From this point on in the profitability test, only absolute amounts are used. The combined total of those segments incurring a loss is larger than the combined total of those segments incurring a profit. Therefore, any segment for which the absolute amount of its operating profit or loss equals or exceeds ` 60 (i.e., 10% of ` 600) meets the profitability test and it therefore a reportable segment. Segments A, C and E meet the profitability test, summarized as follows :

Operating Segment	Absolute amt. of Profit or loss	≥ Rs. 60	
A	450	Yes	(Reportable segment)
B	50	No	
C	350	Yes	(Reportable segment)
D	40	No	
E	210	Yes	(Reportable segment)

If the total external revenue (i.e. sales to unaffiliated customers) of the reportable segments is less than 75% OF TOTAL consolidated revenue, additional operating segments must be identified as reportable segments (even if they do not otherwise qualify as a reportable segment) until at least 75% of total consolidated revenue is included in reportable segments.

Information about all operating segments that did not qualify as reportable segments must be combined and disclosed in an "all other" category.

If an operating segment was identified in the immediately preceding prior period as a reportable segment and management deems that segment to be of continuing significance, information about that segment should continue to be reported separately in the current period even if that segment does not otherwise qualify as a reportable segment in the current period.

If an operating segment qualifies in the current period as a reportable segment but did not qualify as a reportable segment in the prior period(s), prior-period segment data presented for comparative purposes should be restated as if the segment qualified as a reportable segment in the prior period(s).

Question 6

Identify Reportable Segment **(` in '000)**

Segments	Iron	Cement	Steel	Copper	Silver	Total
Segment Revenue						
External Sales	25	2	6	20	46	99
Inter segment Sale	12	6	8	2	1	29

Total	37	8	14	22	47	128
Segment Result (Profit/Loss)	9	16	(3)	(1)	14	35
Segment Assets	81	51	16	16	32	196

Answer :

		Iron	Cement	Steel	Copper	Silver	Total
(i)	**Segment Revenue**						
	Sales (External & Internal)	37	8	14	22	47	128
	% of Total	28.9%	6.25%	10.93%	17.19%	36.71%	
	Status	R	NR	R	R	R	
(ii)	**Segment Result %**	23%	41%	7.69%	2.56%	35.89%	35
	Absolute	9	16	(3)	(1)	14	
	Status	R	R	NR	NR	R	
(iii)	**Segment Assets**	81	51	16	16	32	196
	%	41%	26%	8%	8%	16%	
	Status	R	R	NR	NR	R	

Question 7

Following is the data regarding six segments of Z Ltd. **(` in '000s)**

Particulars	Segments					
	A	B	C	D	E	F
Segment Revenue	150	310	40	30	40	30
Segment Results	25	(95)	5	5	(5)	15
Segment Assets	20	40	15	10	10	5

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

Answer :

		A	B	C	D	E	F	Total
(i)	**Segment Revenue**							
	Absolute	150	310	40	30	40	30	600
	In % term	25%	51.67%	6.67%	5%	6.67%	5%	
	Status	R	R	NR	NR	NR	NR	
(ii)	**Segment Result**	23%	41%	7.69%	2.56%	35.89%		35
	Absolute	25	(95)	5	5	(5)	15	100
	In %	25%	95%	5%	5%	5%	15%	
	Status	R	R	NR	NR	NR	R	
(iii)	**Segment Assets**	81	51	16	16	32		196
	Absolute	20	40	15	10	10	5	100
	In %	20%	40%	15%	10%	10%	5%	
	Status	R	R	R	R	R	NR	

Conclusion : All the Segment is reportable segment and hence contention of director in not proper.

Question 8

Z Ltd., indentified the following geographical segments :

Name of the Segment	% of Segmental Sales in PY	% of Segmental Sales in CY
Southern Division	15%	12%
Northern Division	20%	6%
Western Division	25%	8%
Eastern Division	30%	40%
Central Division	35%	2%

Identify reportable segments.

Answer :

According to 10% check following conclusion in drawn :

Segments	Southern Division	Northern Division	Western Division	Eastern Division	Central Division
Previous Year Status	Reportable	Reportable	Reportable	Reportable	Reportable
Current Year Status	Reportable	Not Reportable	Not Reportable	Reportable	Not Reportable

Conclusion :

Since as per AS-17 if a segment is reportable in previous year in 10% criteria will be reported in current year also even that segment does not fulfil 10% test. Hence all the segment are reportable segment.

Question 9

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

Answer

AS 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 inter- segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

11 AS 22 ACCOUNTING FOR TAXES OF INCOME

1. **Provisions of this Accounting Standard is applicable for:**
   - **a.** Accounting for taxes on income.
   - **b.** This includes the determination of the amount of the expense or saving related to taxes on income in respect of an accounting period and the disclosure of such an amount in the financial statements.
   - **c.** Taxes on income include all domestic and foreign taxes which are based on taxable income.

2. **Not Applicable for**

   For taxes that are payable on distribution of dividends and other distributions made by the enterprise.

3. **Definitions:**
   - **a. Accounting Income (Loss)**

     The net profit or loss for a period as reported in the statement of profit and loss, before deducting income tax expenses or adding income tax saving (PBT).
   - **b. Taxable Income (Tax Losses)**

     The amount of income (loss) for a period determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.
   - **c. Tax Expenses (Tax Savings)**

     The aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.
   - **d. Current tax**

     The amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax losses) for a period.
   - **e. Deferred tax**

     It is the tax effect of timing differences.

4. **Reason of Differences**

   The difference between income as per tax law and account is due to timing difference and permanent difference.

5. **Difference between Timing Difference and Permanent Difference**

Timing Difference	Permanent Difference
(i) Difference between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.	(i) Difference between taxable income and accounting income for a period that originate in one period and are do not reverse subsequently.
(ii) Leads to creation of DTA/DTL.	(ii) Ignored for the purpose of computation of DTA/DTL.
(iii) Unabsorbed depreciation, C/F losses, 43B items.	(iii) Donations disallowed, penalty disallowed.

NOTE:

Under section 43B certain deductions are allowed only payment mad before due date. If such item is paid after the due dale then deduction is available in that year only thus creation of deferred tax is required only if the payment is made after the due date.

6. Recognition of Deferred Tax Assets & Liabilities

a. Tax expenses for the period, includes both current tax as well as deferred for the determination of net profit or loss for the period.

b. Deferred tax should be recognised for all the timing differences, subject to consideration of prudence in respect of deferred tax assets.

c. Situation of Deferred Tax:

Situation	Status
(i) Accounting Income > Taxable Income	• Create Deferred Tax Liability • Journal Entries Profit & Loss Account Dr. To Deferred Tax Liability A/c
(ii) Accounting Income < Taxable Income	• Create Deferred Tax Assets • Journal Entries Deferred Tax Assets A/c Dr. To Profit & Loss A/c

<table>
<tr>
<td>(iii) Accounting Loss and Taxable Income</td>
<td>• Create Deferred Tax Assets for disallowance of expenses.
• Journal Entries
Deferred Tax Assets A/c Dr.
To Profit & Loss A/c</td>
</tr>
<tr>
<td>(iv) Accounting Income and Taxable Loss</td>
<td>• Create Deferred tax Liability for surplus allowance of expenses.
• Journal Entries
Profit & Loss Account A/c Dr.
To Deferred Tax Liability A/c
• Create Deferred Tax Assets for Tax Loss subject to Prudence.
• Journal Entries Dr.
Deferred Tax Assets A/c
To profit & Loss A/c</td>
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<td>(v) Accounting Loss < Taxable Loss</td>
<td>• Create Deferred Tax Assets for disallowance of expense and taxable loss subject to prudence.
• Journal Entries
Deferred Tax Assets A/c Dr.
To Profit & Loss A/c</td>
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<td>(vi) Accounting Loss < Taxable Loss</td>
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Profit & Loss Account
To Deferred Tax Liability A/c
• Create deferred tax assets for taxable loss subject to prudence.
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	Deferred Tax Assets A/c Dr. To Profit & Loss A/c
(vii) Accounting Loss = Taxable Loss	• Create Deferred Tax Assets for Taxable Loss subject to prudence. • Journal Entries • Deferred Tax Assets A/c Dr. • To Profit & Loss A/c

7. Test of Prudence for recognition of Deferred Tax Assets

a. Deferred tax asset should be recognised and carried forward only to the extent that there is reasonable certainty that sufficient taxable income would be available in future against which such deferred tax asset can be realized.

b. Virtual Certainty:

It refers to the extent of certainty, which, for all practical purposes can be considered certain.

- Is a matter of judgment.
- Will have to be evaluated on a case-to-case basis.
- Should be supported by convincing evidence.
- Cannot be based merely on forecasts of performance such as business plans.
- Is not a matter of perception.
- Convincing Evidence
- Evidence is a matter of fact, convincing evidence should be available at the Reporting Date in a concrete form.
- Some examples are:
  - i. A profitable binding Export Order, cancellation of which will result in payment of heavy damages by the defaulting party, constitutes Convincing Evidence.
  - ii. Projection of future profits made by an Enterprise based on future capital expenditure/re-structuring etc. even submitted to an outside agency, e.g. to a

credit agency for obtaining loans and accepted by that agency, is not Convincing Evidence, by itself.

8. Timing Difference of Losses Under the Head Capital Gains:

a. Timing differences by way of losses that arise under the capital gain should be recognized, as a deferred tax asset and carried forward subject to consideration of prudence.

b. A deferred tax asset in respect thereof will be recognized only if there is a "reasonable certainty" that sufficient future taxable income will be available under the head "Capital gain".

NOTE:

Unrecognised deferred tax assets should be reassessed at the end of each year and should be recognised to the extent that sufficient taxable income will be available against which such deferred tax assets can be set-off.

9. Tax Holiday (Explanation to Para 13)

a. The deferred tax in respect of timing differences which reverse during the tax holiday period, should not be recognised to the extent the gross total income of the enterprise is subject to such deductions.

b. The deferred tax in respect of timing difference which reverse after the tax holiday period should be recognized in the year in which the timing differences originate, subject to consideration of prudence.

c. Timing differences which originate first should be considered as reversing first.

10. Measurement and Review of Deferred Tax Assets

(a) Measurement of Current and Deferred Tax

- **Current Tax**

  Current Tax should be measured at the amount expected to be paid to (recovered from) taxation authorities using applicable tax rates and tax laws.

- **Deferred Tax**

  Deferred tax should be measured using the rates and tax laws that have been enacted or substantially enacted by the balance sheet date.

(b) Explanation to Para 21 :

- MAT Tax u/s 115JB is current tax for the period.

- In a period in which a company pays tax under section 115JB of the Act, DTA/DTL should be created using regular tax rate.
- In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the DTA/DTL in respect of timing differences arising during the current period, tax effect should be calculated using regular tax rate.

(c) Review of Deferred Tax Assets:

- The carrying amount of deferred tax assets must be reviewed at each balance sheet date.
- Entity should reduce the carrying amount of deferred tax assets no longer valid.

11. Presentation and Disclosure

(a) Offsetting

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

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

(b) Right of offsetting

- An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment.
- An enterprise should offset deferred tax assets and deferred tax liabilities if the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

Practical Problems

Question 1.

Rama Ltd., has provided the following information:

	`
Depreciation as per accounting records	2,00,000
Depreciation as per income tax records Unamortised preliminary expenses as per tax record	5,00,000 30,000

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

Question 2.

From the following details of A Ltd. For the year ended 31-03-2017, calculate the deffered tax asset or liability as per AS 22 and amount of tax to be debited to the profit and loss account during the year.

Particulars	`
Accounting Profit	600000
Book Profit as per MAT	350000
Profit as per Income Tax Act	60000
Tax Rate	20%
MAT Rate	7.5%

Answer:

CY Tax Expense ` 134250, Deffered Tax Liability 108000

Question 3.

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of` ` 2,00,000 for the year ending 31.3.2015. For the years ending 31.3.2016 and 31.3.2017, it made profits of ` 1,00,000 and ` 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.2015, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off.

There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 2016 and 2017 for tax purposes. Prepare a statement of Profit and Loss for the years ending 2015, 2016 and 2017.

Answer:

Profit or Loss after tax (120000), 60000, 72000.

Question 4.

Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognises revenue from these contracts on percentage of completion method for financial statements during 2014-2015, 2015-2016 and 2016-2017 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 the years 2014-2015, 2015-2016 and 2016-2017 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 2014-2015, 2015-2016 and 2016-2017.

Question 5

ABC Ltd. has three financial statement elements for year ended 31.03.2013, the book value and tax basis value is given below:

	Book Value	**Tax basis Value**
Equipment	20,00,000	12,00,000
Prepaid Insurance	7,50,000	Nil
Warranty liability	5,00,000	Nil

Calculate the deferred tax asset/liability. Tax Rate is 40%.

Question 6

Sun Shine Ltd. Reported income of Rs. 90000 for the financial year 2007-08. Compute the provision for income tax and deferred tax asset/ liability. The following data are provided:

Rent received in advance	Rs. 16000
Income from exempted government security	Rs. 20000

Depreciation deducted for income tax purpose in excess of depreciation

reported for accounting income	Rs. 10000
Income Tax Rate	35 %

Question 7

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 and Loss account.

Answer:

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 to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income-tax Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of ` 200 lakhs depreciation, timing 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 second year, the entire amount of timing difference of ` 400 lakhs will reverse only after tax holiday period and hence, will be recognised in full. Deferred tax liability amounting ` 160 lakhs (40% of `400 lakhs) will be created by charging it to profit and loss account and the total balance of deferred tax liability account at the end of second year will be ` 208 lakhs (48 lakhs + 160 lakhs).