CA INTERMEDIATE

VIVITSU

PAPER 1

# Advanced Accounting Reviewer

## Chapter-wise compilation
## RTP, MTP and PYP questions

**KEY HIGHLIGHTS**

- Easy to Hard Difficulty Level
- Importance levels marked as A, B or C
- Reference to all questions
- Quick recap of important concepts
- Exam Insights
- Last Day Revision Questions Marked

APPLICABLE FOR MAY'25, SEPT'25 AND JAN'26

# ADVANCED ACCOUNTING REVIEWER

## CA Intermediate
## May 2025,
## September 2025 & January 2026

**Publisher:**

VIVITSU

STRIVING TOWARDS KNOWLEDGE

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202 Professional Plaza,17 Punit Nagar,
Near Malhar point, Old Padra Road,
Vadodara – 390007, Gujarat

# Advanced Accounting Reviewer

Published by Vivitsu

8th Edition: January 2025

ISBN: 978-81-983216-7-1

Price: ₹ 750/-

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*This book belongs to future,*

**CA Finalist** ______________________________

***"You become what you believe."***

*-Oprah Winfrey*

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YOU MUST BE WONDERING

## How to Read this book?

**Step 1**
Prioritize more time for 'A' chapters in the ABC analysis

**Step 2**
Identify key concepts in each chapter.

**Step 3**
Solve questions in order, from easy to difficult.

**Step 4**
Focus on solving LDR questions during the final revision

01 02 03 04

### Step 1: Prioritize your chapters

Chapters in the index are categorized as A, B, or C based on their importance. Focus more on 'A' chapters, as they carry the most weight, and give adequate attention to 'B' chapters. While all chapters must be covered, this approach helps manage time efficiently for better results.

### Step 2: Identify key concept

Identify the key concepts for each chapter using the list provided at the start of the chapter. Ensure you understand them thoroughly. If you struggle with a question, revisit the concepts, review them, and strengthen your understanding before moving forward.

### Step 3: Start easy

The questions are segregated AS-wise. Start with Question 1, as they progress from easy to difficult, helping you build confidence throughout the chapter. Pay close attention to the "EXAM INSIGHTS" to avoid common mistakes.

### Step 4: Last Day Revision (LDR)

Focus on solving LDR questions during the final revision. In the 1.5 days before the exam, prioritize these questions as they cover the most critical concepts from each chapter. You'll find a quick summary of LDR question numbers listed right before each chapter for easy reference.

# Table of Contents

**ABC Analysis**

A Very Important, Read on priority

B Moderately Important

C Less critical but still essential

***Ensure you thoroughly read all chapters without skipping any. The ABC analysis is designed to help you prioritize based on past trends, but it should not replace comprehensive preparation.***

C

# CHAPTER 1: INTRODUCTION TO ACCOUNTING STANDARDS

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Grasp objectives & benefits of Accounting Standards<br>• Recognize International Accounting Standard Authorities<br>• Emergence of IFRS as global standards<br>• Differentiate between convergence vs. adoption<br>• Know convergence process of IFRS in India<br>• Objectives & concepts of carve outs/Ins | LDR Questions<br>Q 3 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Benefits of Accounting Standards**

- Standardisation of alternative accounting treatments
- Requirements for additional disclosures
- Comparability of financial statements

**Standards Setting Process**

Step I – Identification of area
Step II – Constitution of study groups
Step III-Preparation of draft and its circulation
Step IV-Ascertainment of views of different bodies on draft
Step V - Finalisation of exposure draft (E.D.)
Step VI – Comments received on exposure draft (E.D.)
Step VII – Modification of the draft
Step VIII – Issue of AS

**Need For Convergence Towards Global Standards**

- Raising funds from international markets:
- Uniformity, Comparability Transparency etc.:
- Comparability of Financial Statements
- Global Investment

**Becoming IFRS compliant**

- Cross border flow of money
- Comparability of financial statements
- Low risk of error
- Listing of companies at global stock exchange
- Greater Transparency
- Helps investors in decision making

**What are 'Carve-outs'?**

Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in economic conditions prevailing in India. These differences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as 'Carve-outs'.

**What are 'Carve in'?**

Additional guidance given in Ind AS over and above what is given in IFRS, is termed as 'Carve in'.

**Question & Answers**

### Question 1

**What do you mean by Carve outs/ins in Ind AS? Explain *(RTP May'24, SM)***

**Answer 1**

Certain changes have been made in Ind AS considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in economic conditions prevailing in India. These differences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as 'Carve-outs'. Additional guidance given in Ind AS over and above what is given in IFRS, is termed as 'Carve in'.

## Question 2

**Explain the objective of 'Accounting Standards' in brief. State the advantages of setting Accounting Standards.** ***(PYP 4 Marks, Nov '22, SM)***

**Answer 2**

Accounting Standards are the written policy documents issued by Government relating to various aspects of measurement, treatment, presentation and disclosure of accounting transactions and events.

**Following are the objectives of Accounting Standards:**

**a)** Accounting Standards harmonize the diverse accounting policies and practices followed by different companies in India.

**b)** Accounting Standards facilitate the preparation of financial statements and make them comparable.

**c)** Accounting Standards give a sense of faith and reliability to the users.

**The main advantages of setting accounting standards are as follows:**

**a)** Accounting Standards make the financial statements of different companies comparable which helps investors in decision making.

**b)** Accounting Standards prevent any misleading accounting treatment.

**c)** Accounting Standards prevent manipulation of data by the management

> **Exam Insights:** The answers of most of the examinees reflected a lack of knowledge to explain the objectives and advantages of setting Accounting Standards and gave vague answers.

## Question 3

LDR

**"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.** ***(MTP 5 Marks, Nov '21 & Apr'23 , PYP 5 Marks, Nov'18) (MTP 4 Marks Aug'24)***

**Answer 3**

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:

**(i)** **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.

**(ii)** **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.

**(iii)** **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.

## Question 4

**What do you mean by Carve outs/ins in Ind AS? Explain.** ***(MTP 4 Marks Dec'24)***

**Answer 4**

Certain changes have been made in Ind AS considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in economic conditions prevailing in India. These differences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as 'Carve- outs'. Additional guidance given in Ind AS over and above what is given in IFRS, is termed as 'Carve in'.

**Multiple Choice Questions (MCQ)**

1. **Accounting Standards for non-corporate entities in India are issued by *(SM)***
   (a) Central Govt
   (b) State Govt.
   (c) Institute of Chartered Accountants of India.
   (d) MCA

**Ans: (c)**

2. **Accounting Standards *(SM)***
   (a) Harmonies accounting policies and eliminate the non-comparability of financial statements
   (b) Improve the reliability of financial statements
   (c) Both (a) and (b).
   (d) Manipulate the data for the management

**Ans: (c)**

3. **It is essential to standardize the accounting principles and policies in order to ensure *(SM)***
   (a) Transparency
   (b) Consistency.
   (c) Comparability
   (d) All the above

**Ans: (d)**

4. **Which committee is responsible for approval of accounting standards and their modification for the purpose of applicability to companies? *(SM)***
   (a) NFRA.
   (b) MCA.
   (c) Central Government Advisory Committee
   (d) IASB

**Ans: (b)**

5. **Global Standards facilitate *(SM)***
   (a) Cross border flow of money.
   (b) Comparability of financial statements
   (c) Uniformity and Transparency of financial statements
   (d) All the three

**Ans: (d)**

C

# CHAPTER 2: FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Framework for preparing and presenting financial statements<br>• Objectives & Qualitative characteristics of financial statements<br>• Recognition and measurement of financial statement elements<br>• Concepts of capital, capital maintenance, and profit determination | LDR<br>**LDR Questions**<br>**Q 14**<br>**Q 18** |

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Users of Financial Statements

• Investors • Employees • Lenders • Suppliers and Creditors • Customers • Govt. • Public

### Elements of Financial Statements

• Asset • Liability • Equity • Income • Expenses

### Balance sheet of an enterprise can be written in form of

A – L = E

*Where:*

A = Aggregate value of asset | L = Aggregate value of liabilities | E = Aggregate value of equity



Closing equity (CE) = Closing Assets (CA) – Closing Liabilities (CL)

Opening Equity (OE) = Opening Assets (OA) – Opening Liabilities (OL)

| | |
|---|---|
| Capital Introduced = C | Income = I |
| Drawings = D | Expenses = E |

CE = OE + C + (I – E) – D

Or CE = OE + C + Profit – D

Or Profit = CE – OE – C + D

Or Profit = (CA – CL) – (OA – OL) – C + D

### Qualitative Characteristics of Financial Statements

| | |
|---|---|
| Understandability | • Information presented in financial statements should be readily understandable by the users with reasonable knowledge of business and economic activities |
| Relevance | • Financial statements should contain relevant information only. Information, which is likely to influence the economic decisions of the users is called relevant. |
| Reliability | • Information must be reliable; that is to say, they must be free from material error and bias. |
| Comparability | • Financial statements should provide both inter-firm and intra-firm comparison |

### Measurement of Elements in Financial Statements

| | |
|---|---|
| Historical cost | • Acquisition price |
| Current Cost | • Assets are carried at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset is acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently. |
| Realisable (Settlement) | • For assets, amount currently realisable on sale of the asset in an orderly disposal. For liabilities, this |

| | |
|---|---|
| Value | • is the undiscounted amount expected to be paid on settlement of liability in the normal course of business. |
| Present Value | • Assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business. |

**Financial Capital Maintenance**

| | |
|---|---|
| At historical cost | • Opening and closing assets are stated at historical costs |
| At current purchasing power | • Restatement at closing prices using average price indices |
| Physical capital maintenance | • Restatement at closing prices using specific price indices |

## Question & Answers

### Question 1

**With regard to financial statements, name any five qualitative characteristics and elements.** ***(RTP May'21)***

**Answer 1**

**(i) Qualitative Characteristics of Financial Statements:** Understandability, Relevance, Comparability, Reliability & Faithful Representation

**(ii) Elements of Financial Statements:**
Asset, Liability, Equity, Income/Gain and Expense/Loss

### Question 2

**"One of the characteristics of financial statements is neutrality"- Do you agree with this statement? Comment.** ***(MTP March '18, 5 Marks, PYP Nov '18 5 Marks, SM ,MTP 4 Marks Apr'24 & Dec'24)***

**Answer 2**

Yes, one of the characteristics of financial statements is neutrality. To be reliable, the information contained in financial statement must be neutral, that is free from bias.

Financial Statements are not neutral if by the selection or presentation of information, the focus of analysis could shift from one area of business to another thereby arriving at a totally different conclusion on the business results.

For example, if the assets of a company primarily consist of trade receivables and insurance claims and the financial statements do not specify that the insurance claims have been lying unrealized for a number of years or that a few key trade receivables have not given balance confirmation certificates, an erroneous conclusion may be drawn on the liquidity of the company. Financial statements are said to depict the true and fair view of the business of the organization by virtue of neutrality.

### Question 3

**State under which head the following accounts should be classified in Balance Sheet, as per Schedule III of the Companies Act, 2013:**

**(i) Share application money received in excess of issued share capital.**
**(ii) Share option outstanding account.**
**(iii) Unpaid matured debenture and interest accrued thereon.**
**(iv) Uncalled liability on shares and other partly paid investments.**
**(v) Calls unpaid.**
**(vi) Intangible Assets under development.**
**(vii) Money received against share warrant.**
**(viii) Cash equivalents.** ***(MTP 4 Marks, Mar'22, 5 Marks, April'19)***

**Answer 3**

(i) Current Liabilities/Other Current Liabilities
(ii) Shareholders' Fund / Reserve & Surplus
(iii)Current liabilities/Other Current Liabilities
(iv)Contingent Liabilities and Commitments
(v) Shareholders' Fund / Share Capital

(vi) Property, Plant & Equipment
(vii) Shareholders' Fund/Money received against share warrants
(viii) Current Assets

## Question 4

**With regard to financial statements name any four.**
**(i) Users**
**(ii) Qualitative characteristics**
**(iii) Elements *(RTP Nov 20, RTP May 19, MTP 5 Marks Mar'23)***

**Answer 4**

**(i) Users of financial statements:**
Investors, Employees, Lenders, Supplies/Creditors, Customers, Government & Public

**(ii) Qualitative Characteristics of Financial Statements:**
Understandability, Relevance, Comparability, Reliability & Faithful Representation

**(iii) Elements of Financial Statements:**
Asset, Liability, Equity, Income/Gain and Expense/Loss

## Question 5

**Explain in brief, the alternative measurement bases, for determining the value at which an element can be recognized in the Balance Sheet or Statement of Profit and Loss. *(MTP 5 Marks, March '19 & April 19, March '21, Oct '23, RTP Nov 18)***

**Answer 5**

The Framework for Recognition and Presentation of Financial statements recognizes four alternative measurement bases for the purpose of determining the value at which an element can be recognized in the balance sheet or statement of profit and loss. These bases are: (i)Historical Cost; (ii)Current cost (iii) Realizable (Settlement) Value and (iv) Present Value.

**A brief explanation of each measurement basis is as follows:**

1. **Historical Cost**: Historical cost means acquisition price. According to this, assets are recorded at an amount of cash or cash equivalent paid or the fair value of the asset at the time of acquisition. Liabilities are generally recorded at the amount of proceeds received in exchange for the obligation.
2. **Current Cost**: Current cost gives an alternative measurement basis. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
3. **Realizable (Settlement) Value:** As per realizable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Liabilities are carried at their settlement values; i.e. the undiscounted amount of cash or cash equivalents paid to satisfy the liabilities in the normal course of business.
4. **Present Value:** Under present value convention, assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities under this convention are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

## Question 6

**What is meant by 'Measurement'? What are the bases of measurement of Elements of Financial Statements? Explain in brief. *(RTP Nov 21, PYP 5 Marks Dec '21)***

**Answer 6**

Measurement is the process of determining money value at which an element can be recognized in the balance sheet or statement of profit and loss. The framework recognizes four alternative measurement bases for the purpose. These bases can be explained as:

| | |
|---|---|
| Historical cost | This is the Acquisition price. According to this, assets are recorded at an amount of cash and cash equivalent paid or the fair value of the assets at time of acquisition. |

| | |
|---|---|
| Current Cost | Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently. |
| Realizable (Settlement) Value | For assets, amount currently realizable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount expected to be paid on settlement of liability in the normal course of business. |
| Present Value | Assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business. |

In preparation of financial statements, all or any of the measurement basis can be used in varying combinations to assign money values to financial items.

## Question 7

**What are the qualitative characteristics of the Financial Statements which improve the usefulness of the information furnished therein? *(PYP 4 Marks Nov '20,) (MTP 4 Marks Mar'24)***

**Answer 7**

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. Financial statements are required to show a true and fair view of the performance, financial position and cash flows of an enterprise. The framework for Preparation and Presentation of Financial Statements suggests that the financial statements should maintain the following four qualitative characteristics to improve the usefulness of the information furnished therein.

1. **Understandability:** The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities and accounting.
2. **Relevance:** The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its materiality. A piece of information is said to be material if its misstatement (i.e., omission or erroneous statement) can influence economic decisions of a user.
3. **Reliability**: To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless transactions and events reported are faithfully represented. The reporting of transactions and events should be neutral, i.e. free from bias and be reported on the principle of 'substance over form'. The information in financial statements must be complete. Prudence should be exercised in reporting uncertain outcome of transactions or events.
4. **Comparability:** Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies.

## Question 8

**Explain how financial capital is maintained at historical cost? Kishore started a business on 1st April, 2019 with ₹ 15,00,000 represented by 75,000 units of ₹20 each. During the financial year ending on 31st March, 2020, he sold the entire stock for ₹ 30 each. In order to maintain the capital intact, calculate the maximum amount, which can be withdrawn by Kishore in the year 2019-20 if Financial Capital is maintained at historical cost. *(PYP 4 Marks Jan 21)***

**Answer 8**

Financial capital maintenance at historical cost: Under this convention, opening and closing assets are stated at respective historical costs to ascertain opening and closing equity. If retained profit is greater than or equals to zero, the capital is said to be maintained at historical costs. This means the business will have enough funds to replace its assets at historical costs. This is quite right as long as prices do not rise.

Maximum amount withdrawn by Kishore in year 2019-20 if financial capital is maintained at historical cost

| Particulars | Financial Capital Maintenance at Historical Cost (₹) |
|---|---|
| Closing equity (₹ 30 x 75,000 units) | 22,50,000 represented by cash |
| Opening equity | 75,000 units x ₹ 20 = 15,00,000 |
| Permissible drawings to keep Capital intact | 7,50,000 (22,50,000 – 15,00,000) |

Thus ₹ 7,50,000 is the maximum amount that can be withdrawn by Kishore in year 2019-20 if financial capital is maintained at historical cost.

## Question 9

**Futura Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31st March, 2022:**

**Amount ₹ in lakhs**

| | |
|---|---|
| **Securities Premium Account** | **80** |
| **Capital Reserve** | **60** |
| **General Reserve** | **90** |

**The company had an accumulated loss of ₹ 250 lakhs on the same date, which it has disclosed under the head "Statement of Profit and Loss" as asset in its Balance Sheet. Comment on accuracy of this treatment in line with Schedule III to the Companies Act, 2013.** ***(MTP 4 Marks Oct '22 SM)***

**Answer 9**

Schedule III to the Companies Act, 2013 provides that debit balance of Statement of Profit and Loss (after all allocations and appropriations) shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative. In this case, the debit balance of profit and loss i.e. ₹ 250 lakhs exceeds the total of all the reserves i.e. ₹ 230 lakhs. Therefore, balance of 'Reserves and Surplus' after adjusting debit balance of profit and loss is negative by ₹ 20 lakhs, which should be disclosed on the face of the balance sheet. Thus the treatment done by the company is incorrect.

## Question 10

**A trader commenced business on April 1, 2020 with ₹ 120,000, represented by 6000 units of a certain product at ₹ 20 per unit. During the year 2020-21 he sold these units at ₹ 30/- per unit and had withdrawn ₹ 60,000. The price of the product at the end of financial year was ₹ 25/- per unit. Compute retained profit of the trader under the concept of physical capital maintenance at current cost. Also, state, whether answer would be different if the trader had not withdrawn any amount.** ***(PYP July'21, 5 Marks) (MTP 5 Marks Sep '23)***

**Answer 10**

Physical Capital Maintenance at Current Cost

In the given case, the specific price index applicable to the product is 125 (25/20X100). Current cost of opening stock = (₹ 1, 20,000 / 100) x 125 Or 6,000 unit's x ₹ 25 = ₹ 1,50,000

Current cost of closing cash = ₹ 1,20,000 (₹ 1,80,000 – ₹ 60,000) Opening equity at closing current costs = ₹ 1,50,000

Closing equity at closing current costs = ₹ 1,20,000 Retained Profit = ₹ 1,20,000 – ₹ 1,50,000 = (-) ₹ 30,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund of ₹ 1,20,000 is not sufficient to buy 6,000 units again at increased price of ₹ 25 per unit. The drawings should have been restricted to ₹ 30,000 (₹ 60,000 – ₹ 30,000).

**If the trader had not withdrawn any amount, then the answer would have been as below:**

Current cost of opening stock = ₹ 1,80,000

Opening equity at closing current costs = ₹ 1,50,000

Retained Profit = ₹ 1,80,000 – ₹ 1,50,000 = ₹ 30,000

If the trader had not withdrawn any amount, then the retained profit would have been₹ 30,000.

## Question 11

**Opening Balance Sheet of Mr. A is showing the aggregate value of assets, liabilities and equity Rs. 8 lakh, Rs. 3 lakh and Rs. 5 lakh respectively. During accounting period, Mr. A has the following transactions:**

**(1) Earned 10% dividend on 2,000 equity shares held of Rs. 100 each**

(2) **Paid Rs. 50,000 to creditors for settlement of Rs. 70,000**
(3) **Rent of the premises is outstanding Rs. 10,000**
(4) **Mr. A withdrew Rs. 9,000 for his personal use.**

**You are required to show the effect of above transactions on Balance Sheet in the form of Assets - Liabilities = Equity after each transaction.**
***(MTP 5 Marks, April 21, April 22, SM, MTP 4 Marks Apr'24)***

**Answer 11**

**Effects of each transaction on Balance sheet of the trader is shown below:**

| Transactions | | Assets Rs. lakh | - | Liabilities Rs. lakh | = | Equity Rs. lakh |
|---|---|---|---|---|---|---|
| Opening | | 8.00 | - | 3.00 | = | 5.00 |
| (1) | Dividend earned | 8.20 | - | 3.00 | = | 5.20 |
| (2) | Settlement of Creditors | 7.70 | - | 2.30 | = | 5.40 |
| (3) | Rent Outstanding | 7.70 | - | 2.40 | = | 5.30 |
| (4) | Drawings | 7.61 | - | 2.40 | = | 5.21 |

## Question 12

**Shiva started a business on 1st April 2022 with ₹ 15,00,000 represented by 80,000 units of ₹ 25 each. During the financial year ending on 31st March, 2023, he sold the entire stock for ₹ 35 each. In order to maintain the capital intact, calculate the maximum amount, which can be withdrawn by Shiva in the year 2022-23 if Financial Capital is maintained at historical cost.** ***(RTP May'24) (RTP May'21, Nov'19) (Same concept different figures SM, RTP Nov'18)***

**Answer 12**

| Particulars | Financial Capital Maintenance at Historical Cost (₹) |
|---|---|
| Closing equity (₹ 35 x 80,000 units) | 28,00,000 represented by cash |
| Opening equity | 80,000 units x ₹ 25 = 20,00,000 |
| Permissible drawings to keep Capital intact | 8,00,000 (28,00,000 – 20,00,000) |

## Question 13

**A Ltd. has entered into a binding agreement with Gamma Ltd. to buy a custom-made machine Rs.1,00,000. At the end of 20X1-X2, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and it will be scrapped after delivery. The expected scrap value is nil. You are required to advise the accounting treatment and give necessary journal entry in the year 20X1-X2.** ***(RTP May'20, May'23 & Nov '23, SM)***

**Answer 13**

A liability is recognized when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, A Ltd. should recognize a liability of Rs.1,00,000 to Gamma Ltd. When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognized as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognized as an expense.

**Journal entry**

| | | | |
|---|---|---|---|
| Loss on change in production method | Dr. | 1,00,000 | |
| To Gamma Ltd. | | | 1,00,000 |
| (Loss due to change in production method) | | | |
| Profit and loss A/c | Dr. | 1,00,000 | |
| To Loss on change in production method | | | 1,00,000 |
| (Loss transferred to profit and loss account) | | | |

## Question 14 — LDR

**Mrs. A is showing the consolidated aggregate opening balance of equity, liabilities and assets of ₹ 6 lakh, 4 lakh and 10 lakhs respectively. During the current year Mrs. A has the following transactions:**

1. **Received 20% dividend on 10,000 equity shares of ₹ 10 each held as investment.**
2. **The amount of ₹ 70,000 is paid to creditors for settlement of ₹ 90,000.**
3. **Salary is pending by ₹ 20,000.**
4. **Mrs. A's drawing ₹ 20,000 for her personal use.**

**You are required to prepare the statement of the effect of aforesaid each transaction on closing balance sheet in the form of Assets – Liabilities = Equity after each transaction.** ***(PYP 5 Marks, Dec '21)***

**Answer 14**

**Effect of each transaction on Balance sheet of Mrs. A is shown below:**

| Transactions | Assets ₹ lakh | - | Liabilities ₹ lakh | = | Equity ₹ lakh |
|---|---|---|---|---|---|
| Opening | 10.00 | - | 4.00 | = | 6.00 |
| (1) Dividend earned | 10.20 [10.00+0.20] | - | 4.00 | = | 6.20 [6.00+0.20] |
| (2) Settlement of Creditors | 9.50 [10.20-0.70] | - | 3.10 [4.00-0.90] | = | 6.40 [6.20+0.20] |
| (3) Salary Outstanding | 9.50 | - | 3.30 [3.10+0.20] | = | 6.20 [6.40-0.20] |
| (4) Drawings | 9.30 [9.50-0.20] | - | 3.30 | = | 6.00 [6.20-0.20] |

## Question 15

**The following extract of Balance Sheet of Ram Ltd. (a non-investment company) was obtained:**

**Balance Sheet (Extract) as on 31st March ,2022**

| **Liabilities** | **₹** |
|---|---|
| **Issued and subscribed capital:** | |
| **20,000, 14% Preference shares of ₹ 100 each fully paid** | **20,00,000** |
| **1,20,000 Equity shares of ₹ 100 each, ₹ 80 paid-up** | **96,00,000** |
| **Capital reserves (₹ 1,50,000 is revaluation reserve)** | **1,95,000** |
| **Securities premium** | **50,000** |
| **15% Debentures** | **65,00,000** |
| **Unsecured loans: Public deposits repayable after one year** | **3,70,000** |
| **Investment in shares, debentures, etc.** | **75,00,000** |
| **Profit and Loss account (debit balance)** | **15,00,000** |

**You are required to compute Effective Capital as per the provisions of Schedule V to Companies Act, 2013.** ***(MTP 5 Marks, Sep 22 & Oct '23) (SM)***

**Answer 15**

**Computation of Effective capital**

| | ₹ |
|---|---|
| Paid-up share capital- | |
| 20,000, 14% Preference shares | 20,00,000 |
| 1,20,000 Equity shares | 96,00,000 |
| Capital reserves (excluding revaluation reserve) | 45,000 |
| Securities premium | 50,000 |
| 15% Debentures | 65,00,000 |
| Public Deposits | 3,70,000 |
| (A) | 1,85,65,000 |
| Investments | 75,00,000 |
| Profit and Loss account (Dr. balance) | 15,00,000 |
| (B) | 90,00,000 |
| Effective capital (A–B) | 95,65,000 |

## Question 16

**As on 1st April, 2021 opening Balance Sheet of Mr. Mohanty is showing the aggregate value of Assets, Liabilities and Equity ₹ 12 Lakhs, 3 Lakhs and 9 lakhs respectively.**

**During the accounting period 01/04/2021 to 31/03/2022, Mr. Mohanty has the following transactions:**

**(1) A liability of ₹ 50,000 was finally settled at a discount of 2%.**

**(2) Dividend earned @ 15% on 1,000 (F.V 100 each) Equity shares held @ ₹ 12,000.**

**(3) Rent of the premises paid ₹ 20,000.**

**(4) Mr. Mohanty withdrew ₹ 10,000 for personal purposes and also withdrew Goods worth ₹ 5,000 for personal purposes.**

**(5) ₹ 15,000 were received against Bill Receivables.**

**You are required to show the effect of the above transactions on Balance Sheet in the form of Assets - Liabilities = Equity equation after each transaction.** ***(PYP 4 Marks Nov '22)***

**Answer 16**

**Effects of each transaction on Balance sheet of the trader is shown below:**

| Transactions | Assets | - | Liabilities | = | Equity |
|---|---|---|---|---|---|
| | ₹ lakh | | ₹ lakh | | ₹ lakh |
| Opening | 12 | - | 3 | = | 9 |
| (1) Settlement of Creditors | 12 – 0.49<br>11.51 | -<br>- | 3 – 0.50<br>2.5 | =<br>= | 9.0 + 0.01<br>9.01 |
| (2) Dividend earned | 11.51 + 0.15<br>11.66 | -<br>- | <br>2.5 | <br>= | 9.01+ 0.15<br>9.16 |
| (3) Rent paid | 11.66 -0.20<br>11.46 | <br>- | <br>2.5 | <br>= | 9.16 -0.20<br>8.96 |
| (4) Drawings | 11.46 -0.15<br>11.31 | <br>- | <br>2.5 | <br>= | 8.96 -0.15<br>8.81 |
| (5) *Money received against Bills receivables | 11.31+0.15 -0.15<br>11.31 | <br>- | <br>2.5 | <br>= | <br>8.81 |

*No change as cash received from bills receivable will have impact on individual asset only (will reduce bill receivables with corresponding increase in cash).

## Question 17

**Mille started a business on 01.04.2022 with a capital of ₹ 15,00,000. She purchased ₹ 1,500 units of stock at ₹ 1,000 each. She sold the entire stock for ₹ 1,500 each unit till 31.03.2023.**

**You are required to calculate the maximum amount which can be withdrawn by Mille in order to keep her capital intact, if Financial Capital is maintained at:**

**(i) Historical Cost (ii) Current Purchasing Power (opening index at 100 and closing index at 125)**

**(iii) Physical Capital Maintenance**

**(Price per unit at the end of year is ₹ 1,350)** ***(PYP 5 Marks May '23)***

**Answer 17**

**Financial Capital Maintenance at historical Costs**

| Sr. No. | Particulars | Computation | ₹ |
|---|---|---|---|
| (i) | Opening Equity | 1,500 x 1,000 | 15,00,000 |
| (ii) | Closing Equity | 1,500 x 1,500 | 22,50,000 |
| (iii) | Maximum Drawing | (ii)- (i) | 7,50,000 |

**Financial Capital Maintenance at current purchasing power**

| Sr. No. | Particulars | Computation | ₹ |
|---|---|---|---|
| (i) | Opening Equity | 1,500 x 1,000 x 125/100 | 18,75,000 |
| (ii) | Closing Equity | 1,500 x 1,500 | 22,50,000 |
| (iii) | Maximum Drawing | (ii)- (i) | 3,75,000 |

**Financial Capital Maintenance at Physical Capital Maintenance**

| Sr. No. | Particulars | Computation | ₹ |
|---|---|---|---|
| (i) | Opening Equity | 1,500 x1,350 | 20,25,000 |

| | | | |
|---|---|---|---|
| (ii) | Closing Equity | 1,500 x 1,500 | 22,50,000 |
| (iii) | Maximum Drawing | (ii)- (i) | 2,25,000 |

## Question 18

LDR

**Summarized Balance Sheet of Cloth Trader as on 31.03.2021 is given below:**

| Equity & Liabilities | Amount (₹) | Assets | Amount (₹) |
|---|---|---|---|
| Proprietor's Capital | 3,00,000 | Property, plant and equipment | 3,60,000 |
| Profit & Loss Account | 1,25,000 | Closing Inventory | 1,50,000 |
| 10% Loan Account | 2,10,000 | Trade receivables | 1,00,000 |
| Trade payables | 50,000 | Deferred Expenses | 50,000 |
| | | Cash & Bank | 25,000 |
| | 6,85,000 | | 6,85,000 |

**Additional Information is as follows:**

(1) The remaining life of Property, plant and equipment is 8 years. The pattern of use of the asset is even. The net realisable value of Property, plant and equipment on 31.03.2022 was ₹ 3,25,000.

(2) Purchases and Sales in 2021-22 amounted to ₹ 22,50,000 and ₹ 27,50,000 respectively.

(3) The cost and net realizable value of inventory on 31.03.2022 were ₹ 2,00,000 and ₹ 2,50,000 respectively.

(4) Expenses including interest on loan for the year amounted to ₹ 78,000.

(5) Deferred Expenses are amortized equally over 5 years.

(6) Sundry Debtors on 31.03.2022 are ₹ 1,50,000 of which ₹ 5,000 is doubtful. Collection of another ₹ 25,000 depends on successful re-installation of certain product supplied to the customer;

(7) Closing Sundry Creditors are ₹ 75,000, likely to be settled at 10% discount.

(8) Cash balance as on 31.03.2022 is ₹ 4,22,000.

(9) There is an early repayment penalty for the loan of ₹ 25,000. You are required to prepare: (Not assuming going concern)

 (1) Profit & Loss Account for the year 2021-22.

 (2) Balance Sheet as on 31st March, 2022. *(RTP May'22, Nov'22, PYP 5 Marks May'19) (Same concept different figures PYP 4 Marks Nov'20, SM)*



**Answer 18**

**Profit and Loss Account for the year ended 2021-22(not assuming going concern)**

| Particulars | Amount ₹ | Particulars | Amount ₹ |
|---|---|---|---|
| To Opening Stock | 1,50,000 | By Sales | 27,50,000 |
| To Purchases | 22,50,000 | By Closing Stock | 2,50,000 |
| To Expenses | 78,000 | By Trade payables | 7,500 |
| To Depreciation | 35,000 | | |
| To Provision for doubtful debts | 30,000 | | |
| To Deferred expenses | 50,000 | | |
| To Loan penalty | 25,000 | | |
| To Net Profit (b.f.) | 3,89,500 | | |
| | 30,07,500 | | 30,07,500 |

**Balance Sheet as at 31st March, 2022 (not assuming going concern)**

| Liabilities | Amount ₹ | Assets | Amount ₹ |
|---|---|---|---|
| Capital | 3,00,000 | Fixed Assets | 3,25,000 |
| Profit & Loss A/c | 5,14,500 | Inventory | 2,50,000 |
| 10% Loan | 2,35,000 | Trade receivables (less provision) | 1,20,000 |
| Trade payables | 67,500 | Deferred expenses | Nil |
| | | Bank | 4,22,000 |
| | 11,17,000 | | 11,17,000 |

Question 19

**M/s Shyam, a proprietorship firm runs a business of stationary items. It provides you the following information relating to assets and liabilities:**

| Assets & Liabilities | As on 01.04.2019 | As on 31.03.2020 |
|---|---|---|
| Creditors | 20,000 | 15,000 |
| Outstanding Expenses | 600 | 800 |
| Fixed Assets | 12,000 | 13,000 |
| Stock | 10,000 | 12,000 |
| Cash in hand | 7,500 | 2,000 |
| Cash at Bank | 2,500 | 10,000 |
| Debtors | ? | 18,000 |

**Details of the year's transactions are as follows:**

| | | |
|---|---|---|
| (1) | Discounts allowed to Debtor | 4,000 |
| (2) | Returns from debtors | 1,450 |
| (3) | Bad debts | 500 |
| (4) | Total sales (Cash and Credit) | 72,000 |
| (5) | Discount allowed by creditors | 700 |
| (6) | Returns to creditors | 400 |
| (7) | Receipts from debtors paid into Bank | 76,000 |
| (8) | Cash purchases | 1,000 |
| (9) | Expenses paid by cash | 9,000 |
| (10) | Drawings by cheque | 500 |
| (11) | Purchase of Property, Plant & Equipment by cheque | 4,000 |
| (12) | Cash deposited into bank | 5,000 |
| (13) | Cash withdrawn from bank | 9,000 |
| (14) | Payments to creditors by cheque | 60,000 |



**No Property, Plant & Equipment were sold during the year. Any difference in cash account to be considered as cash sales. You are required to prepare Trading and Profit & Loss Account for the year ended 31.03.2020 and the Balance Sheet as at 31.03.2020 from the given information.** ***(MTP 16 Marks, Oct '21, May'20)***

**Answer 19**

**In the books of M/s Shyam Trading and Profit and Loss Account for the year ended 31st March, 2020**

| Particulars | ₹ | ₹ | Particulars | ₹ | ₹ |
|---|---|---|---|---|---|
| To Opening stock | | 10,000 | By Sales: | | |
| To Purchases: | | | Cash | 500 | |
| Cash | 1,000 | | Credit | 71,500 | |
| Credit (W.N. 3) | 56,100 | | Less: Returns | (1,450) | 70,550 |
| | 57,100 | | By Closing Stock | | 12,000 |
| Less: Returns | (400) | 56,700 | | | |
| To Gross Profit c/d | | 15,850 | | | |
| | | 82,550 | | | 82,550 |
| To Discount allowed | | 4,000 | By Gross profit b/d | | 15,850 |
| To Bad Debts | | 500 | By Discount received | | 700 |
| To General expenses (W.N. 5) | | 9,200 | By Net Loss (balancing fig.) | | 150 |
| To Depreciation (W.N. 4) | | 3,000 | | | |
| | | **16,700** | | | **16,700** |

**Balance Sheet as at 31st March, 2020**

| Liabilities | | ₹ | Assets | | ₹ |
|---|---|---|---|---|---|
| Capital (W.N. 1) | 39,850 | | Fixed Assets | 12,000 | |
| Less: Net loss | 150 | | Add: New asset | 4,000 | |

| | | | | | |
|---|---|---|---|---|---|
| | 39,700 | | | 16,000 | |
| Less: Drawings | 500 | 39,200 | Less: Depreciation | 3,000 | 13,000 |
| Sundry creditors | | 15,000 | Stock in trade | | 12,000 |
| Expenses outstanding | | 800 | Sundry debtors (W.N. 2) | | 18,000 |
| | | | Cash in hand | | 2,000 |
| | | | Cash in Bank | | 10,000 |
| | | **55,000** | | | **55,000** |

**Working Notes:**

**(1) Ascertainment of Opening Capital - Statement of Affairs as at 1.4.19**

| Liabilities | ₹ | Assets | ₹ |
|---|---|---|---|
| Sundry creditors | 20,000 | Fixed Assets | 12,000 |
| Outstanding expenses | 600 | Stock | 10,000 |
| Prasad's Capital (Balancing figure) | 39,850 | Debtors | 28,450 |
| | | Cash in hand | 7,500 |
| | | Cash at Bank | 2,500 |
| | **60,450** | | **60,450** |

**(2) Sundry Debtors Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Balance b/d (bal. fig) | 28,450 | By Cash | 76,000 |
| (3) To Sales (**72**,000 – 500) | 71,500 | By Discount | 4,000 |
| | | By Returns (sales) | 1,450 |
| | | By Bad debts | 500 |
| | | By Balance c/d (given) | 18,000 |
| | **99,950** | | **99,950** |

**(4) Sundry Creditors Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Bank – Payments | 60,000 | By Balance b/d | 20,000 |
| To Discount | 700 | By Purchases – credit (Balancing figure) | 56,100 |
| To Returns | 400 | | |
| To Balance c/d (closing balance) | 15,000 | | |
| | **76,100** | | **76,100** |

**(5) Depreciation on Property, Plant & Equipment**

| | ₹ |
|---|---|
| Opening balance of Property, Plant & Equipment | 12,000 |
| Add: Additions | **4,000** |
| | 16,000 |
| Less: Closing balance of Property, Plant & Equipment | (**13,000**) |
| Depreciation | **3,000** |

**(6) Expenses to be shown in profit and loss account**

| | |
|---|---|
| Expenses (in cash) | 9,000 |
| Add: Outstanding of 2020 | **800** |
| | 9,800 |
| Less: Outstanding of 2019 | **600** |
| | **9,200** |

**(7) Cash and Bank Account**

| **Particulars** | **Cash** | **Bank** | **Particulars** | **Cash** | **Bank** |
|---|---|---|---|---|---|
| | ₹ | ₹ | | ₹ | ₹ |
| To balance b/d | 7,500 | 2,500 | By Purchases | 1,000 | - |
| To debtors | - | 76,000 | By Expenses | 9,000 | |

| | | | | | |
|---|---|---|---|---|---|
| To Banks (C) | 9,000 | - | By Property, Plant & Equipment | | 4,000 |
| To Cash (C) | - | 5,000 | By Drawings | | 500 |
| To sales (balancing as cash sales) | 500 | - | By Creditors | | 60,000 |
| | | | By Cash (C) | | 9,000 |
| | | | By Bank (C) | 5,000 | |
| | | | By Balance c/d | **2,000** | **10,000** |
| | **17,000** | **83,500** | | **17,000** | **83,500** |

## Question 20

**The following is the Balance Sheet of Vivit and Su as on 1 st April, 2024:**

| Equity and Liabilities | ₹ | Assets | ₹ |
|---|---|---|---|
| Capital Accounts: | | Building | 1,00,000 |
| Vivit | 1,50,000 | Machinery | 65,000 |
| Su | 75,000 | Stock | 40,000 |
| Creditors for goods | 30,000 | Debtors | 50,000 |
| Creditors for expenses | 25,000 | Bank | 25,000 |
| | 2,80,000 | | 2,80,000 |

**They give you the following additional information:**

(i) Creditors' Velocity 1.5 month & Debtors' Velocity 2 months. Here velocity indicates the no. of times the creditors and debtors are turned over a year.
(ii) Stock level is maintained uniformly in value throughout all over the year.
(iii) Depreciation on machinery is charged @ 10%, Depreciation on building @ 5% in the current year.
(iv) Cost price will go up 15% as compared to last year and also sales in the current year will increase by 25% in volume.
(v) Rate of gross profit remains the same.
(vi) Business Expenditures are ₹ 50,000 for the year. All expenditures are paid off in cash.
(vii) Closing stock is to be valued on LIFO Basis.
(viii) All sales and purchases are on credit basis and there are no cash purchases and sales.

You are required to prepare Trading, Profit and Loss Account, Trade Debtors Account and Trade Creditors Account for the year ending 31.03.2025.*(MTP 16 Marks April 23 & Nov '21)*

**Answer 20**

**Trading and Profit and Loss account for the year ending 31st March, 2025**

| Particulars | Rs. | Particulars | Rs. |
|---|---|---|---|
| To Opening Stock | 40,000 | By Sales | 4,31,250 |
| To Purchases (Working Note) | 3,45,000 | By Closing Stock | 40,000 |
| To Gross Profit c/d (20% on sales) | **86,250** | | |
| | **4,71,250** | | **4,71,250** |
| To Business Expenses | 50,000 | By Gross Profit b/d | 86,250 |
| To Depreciation on: | | | |
| Machinery **6,500** | | | |
| Building **5,000** | 11,500 | | |
| To Net profit | **24,750** | | |
| | **86,250** | | **86,250** |

**Trade Debtors Account**

| Particulars | Rs. | Particulars | Rs. |
|---|---|---|---|
| To Balance b/d | 50,000 | By Bank (bal. fig.) | 4,09,375 |
| To Sales | **4,31,250** | By Balance c/d (1/6 of 4,31,250) | **71,875** |
| | **4,81,250** | | **4,81,250** |

**Trade Creditors Account**

| Particulars | Rs. | Particulars | Rs. |
|---|---|---|---|
| To Bank (Balancing figure) | 3,31,875 | By Balance b/d | 30,000 |
| To Balance c/d/ (1/8 of Rs. 3,45,000) | **43,125** | By Purchases | 3,45,000 |
| | **3,75,000** | | 3,75,000 |

**Working Note:**

| | | Rs. |
|---|---|---|
| (i) | Calculation of Rate of Gross Profit earned during previous year | |
| A | Sales during previous year (= 50,000 x 12/2) | 3,00,000 |
| B | Purchases (Rs. 30,000 x 12/1.5) | 2,40,000 |
| C | Cost of Goods Sold (Rs. 40,000 + Rs. 2,40,000 — Rs. 40,000) | 2,40,000 |
| D | Gross Profit (A-C) | 60,000 |
| E | Rate of Gross Profit $\frac{Rs.60,000}{Rs.3,00,000}$ X 100 | 20% |
| (ii) | Calculation of sales and Purchases during current year | Rs. |
| A | Cost of goods sold during previous year | 2,40,000 |
| B | Add: Increases in volume @ 25 % | 60,000 |
| | | 3,00,000 |
| C | Add: Increase in cost @ 15% | 45,000 |
| D | Cost of Goods Sold during Current Year | 3,45,000 |
| E | Add: Gross profit @ 25% on cost (20% on sales) | 86,250 |
| F | Sales for current year [D+E] | 4,31,250 |

## Multiple Choice Questions (MCQs)

**1. The 'going concern' concept assumes that *(SM)***

(a) The business can continue in operational existence for the foreseeable future
(b) The business cannot continue in operational existence for the foreseeable future.
(c) The business is continuing to be profitable.
(d) The business cannot continue if it is not able to earn profits.

**Ans: (a)**

**2. Two principal qualitative characteristics of financial statements are *(SM)***

(a) Understandability and materiality
(b) Relevance and reliability
(c) Relevance and materiality
(d) Comparability and materiality.

**Ans: (b)**

**3. All of the following are components of financial statements except *(SM)***

(a) Balance sheet
(b) Statement of Profit and loss
(c) Human responsibility report
(d) Social responsibility report.

**Ans: (c)**

**4. An accounting policy can be changed if the change is required *(SM)***

(a) By statute or accounting standard
(b) For more appropriate presentation of financial statements
(c) Both (a) and (b)
(d) By statute as well as accounting standards.

**Ans: (c)**

**5. Value of equity may change due to *(SM)***

(a) Contribution from or Distribution to equity participants
(b) Income earned
(c) expenses incurred
(d) All the three.

**Ans: (d)**

# CHAPTER 3: APPLICABILITY OF ACCOUNTING STANDARDS

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Comprehend status of Accounting Standards<br>• Understand applicability of Accounting Standards | LDR Questions<br>Q 6 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Criteria for classification of Non-company entities for applicability of Accounting Standards**

**Level I Entities**

Non-company entities are classified as Level I if, at the end of the relevant accounting period, they meet any of these criteria:

- Listed or in the process of listing on any stock exchange (India or abroad).
- Banks, financial institutions, or insurance businesses.
- Engaged in commercial, industrial, or business activities with a turnover over ₹250 crore in the previous year.
- Have borrowings (including public deposits) over ₹50 crore in the previous year.
- Holding or subsidiary entities of any of the above.

**Level II Entities**

Non-company entities that are not Level I but meet any of these criteria are classified as Level II:

- Turnover between ₹50 crore and ₹250 crore in the previous year.
- Borrowings (including public deposits) between ₹10 crore and ₹50 crore in the previous year.
- Holding or subsidiary entities of any of the above

**Level III Entities**

Non-company entities not in Level I or II are classified as Level III if they meet any of these criteria:

- Turnover between ₹10 crore and ₹50 crore in the previous year.
- Borrowings (including public deposits) between ₹2 crore and ₹10 crore in the previous year.
- Holding or subsidiary entities of any of the above.

**Level IV Entities**

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

**Question & Answers**

**Question 1**

**What are the issues, with which Accounting Standards deal?** ***(RTP Nov 20, SM)***
***(MTP 4 Marks Mar'24)***

**Answer 1**

Accounting Standards deal with the issues of (i) Recognition of events and transactions in the financial statements, (ii) Measurement of these transactions and events, (iii) Presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and (iv) Disclosure requirements.

## Question 2

**List the criteria to be applied for rating a non-corporate entity as Level-I entity and Level II entity for the purpose of compliance of Accounting Standards in India.** ***(SM, PYP 4 Marks Jan 21)***

**Answer 2**

Criteria for classification of Non-company Entities as decided by the Institute of Chartered Accountants of India

***Level I Entities***

***Non-company 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 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 entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees two-fifty crore in the immediately preceding accounting year.

(iv) All entities engaged in commercial, industrial or business activities having borrowings (including public deposits) in excess of rupees fifty crore at any time during the immediately preceding accounting year.

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

***Level II Entities***

***Non-company 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 entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) exceeds rupees fifty crore but does not exceed rupees two-fifty crore in the immediately preceding accounting year.

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

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

## Question 3

**(a) A company with a turnover of ₹ 225 crores and borrowings of ₹ 51 crore during the year ended 31st March, 2021, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3. 2021. Advise the management on the exemptions that are available as per the Companies (Accounting Standards) Rules, 2021.**

**(b) An organization whose objects are charitable or religious, believes that the Accounting Standards are not applicable to it since only a very small proportion of its activities are business in nature. Comment. (*RTP May '22)***

**Answer 3**

**(a)** The question deals with the issue of Applicability of Accounting Standards for corporate entities. The companies can be classified under two categories viz SMCs and Non-SMCs under the Companies (Accounting Standards) Rules, 2021. As per the Companies (Accounting Standards) Rules, 2021, criteria for above classification as SMCs, are:

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

- 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;
- which is not a bank, financial institution or an insurance company;
- whose turnover (excluding other income) does not exceed rupees two-fifty crores in the immediately preceding accounting year;
- which does not have borrowings (including public deposits) in excess of rupees fifty crores at any time during the immediately preceding accounting year; and
- which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Since, XYZ Ltd.'s turnover was ₹ 225 crores which does not exceed ₹ 250 crores but borrowings of ₹ 51 crore are more than ₹ 50 crores, it is not a small and medium sized company (SMC). The exemptions available to SMC are not available to this company.

**(b)** Accounting Standards apply in respect of any enterprise (whether organized in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes. Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.

## Question 4

**Based upon criteria for rating of non-corporate entity, categorize the following as Level I, Level II and Level III Level IV entities for the purpose of compliance of Accounting Standards in India.**

**a) Rama Textiles whose turnover (excluding other income) exceeds ten crore but does not exceed rupees fifty crore in the immediately preceding accounting year.**

**b) Star Industries is having borrowings (including public deposits) in excess of rupees two crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.**

**c) Vivit Su Industries is having borrowings (including public deposits) less than rupees fifty lakh at any time during the immediately preceding accounting year.**

**d) SS Finance is a financial institution carrying its business in India since last 10 years.**

**e) DD Finance, holding company of SS Finance. (Entity mentioned at Point (v) above)**

**f) Reliable Co-op Bank, a co-operative bank, carrying banking operations since last 15 years. *(RTP May'24)***

**Answer 4**

a) Level III Entity – Rama textiles, whose turnover (excluding other income) exceeds rupees ten crore but does not exceed rupees fifty crore in the immediately preceding accounting year.

b) Level III Entity – Star industries is having borrowings (including public deposits) in excess of rupees two crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

c) Level IV Entity– Vivit Su Industries is having borrowings (including public deposits) less than rupees fifty lakhs at any time during the immediately preceding accounting year.

d) Level I Entity – SS is a financial institutions carrying its business in India since last 10 years.

e) Level I Entity – DD finance, Holding company of SS finance (Entity mentioned in point (d) above).

f) Level I Entity – Reliable co-operative banks carrying on banking business since last 15 years.

## Question 5

**List down the applicable criteria under the companies (Accounting Standards) Rule, 2021, to classify a company as Small and Medium Sized Company (SMC). *(PYP 5 Marks Nov'23)***

**Answer 5**

Criteria for classification of Companies under the Companies (Accounting Standards) Rules, 2021 to classify a company as Small and Medium-Sized Company (SMC): "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 two-fifty crores in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees fifty crores 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

## Question 6

LDR

**M/s X & Co. (a partnership firm) had a turnover of ₹ 5 crores (excluding other income) and borrowings of ₹ 1.5 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 31.3.2022. Advise the management of M/s X & Co in**

**respect of the exemptions of provisions of ASs, as per the directive issued by the ICAI.** *(MTP 5 Marks Oct '22) (Same concept different figures MTP Oct'18 5 Marks, SM)*

**Answer 6**

The question deals with the issue of Applicability of Accounting Standards to a non-corporate entity. For availment of the exemptions, first of all, it has to be seen that M/s Omega & Co. falls in which level of the non-corporate entities. Its classification will be done on the basis of the classification of non-corporate entities as prescribed by the ICAI. According to the ICAI, non- corporate entities can be classified under 4 levels viz Level I, Level II, Level III and Level IV entities.

**Non-corporate entities which meet following criteria are classified as Level IV entities:**

(i) All entities engaged in commercial, industrial or business activities, whose turnover (excluding other income) does not exceed rupees ten crores in the immediately preceding accounting year.

(ii) All entities engaged in commercial, industrial or business activities having borrowings (including public deposits) does not exceed rupees two crores at any time during the immediately preceding accounting year.

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

As the turnover of M/s Omega & Co. is less than ₹ 10 crores and borrowings less than ₹ 2 crores, it falls under Level IV non-corporate entities. In this case, AS 3, AS 14, AS 17, AS 18, AS 20, AS 21, AS 23, AS 24, AS 25, AS 27 and AS 28 will not be applicable to M/s Omega & Co. Relaxations from certain requirements in respect of AS 10, AS 11, AS 13, AS 15, AS 19, AS 22, AS 26 and AS 29 are also available to M/s Omega

## Multiple Choice Questions (MCQs)

1. **Non-corporate entities which are not Level I entities whose turnover (excludingother income) exceeds rupees _______but does not exceed rupees two-fifty crores in the immediately preceding accounting year are classified as Level II entities.** *(SM)*
   (a) five crores.
   (b) two crores.
   (c) fifty crores.
   (d) ten crores.

**Ans: (c)**

2. **The following Accounting Standard is not applicable to Non-Corporate Entities falling in Level II in its entirety.** *(SM)*
   (a) AS 10.
   (b) AS 17.
   (c) AS 2.
   (d) AS 13.

**Ans: (b)**

3. **All non-corporate entities engaged in commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees 250 crores in the immediately preceding accounting year, are classified as** *(SM)*
   (a) Level II entities.
   (b) Level I entities.
   (c) Level III entities.
   (d) Level IV entities.

**Ans: (b)**

4. **All non-corporate entities engaged in commercial, industrial or business activities having borrowings (including public deposits) in excess of rupees two crores but does not exceed rupees ten crores at any time during the immediately preceding accounting year.** *(SM)*
   (a) Level II entities.
   (b) Level IV entities.
   (c) Level III entities.
   (d) Level I entities.

**Ans: (c)**

**5. "Small and Medium Sized Company" (SMC) means, a company- *(SM)***

(a) which may be a bank, financial institution or an insurance company.

(b) whose turnover (excluding other income) does not exceed rupees two-fifty crores in the immediately preceding accounting year;

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

(d) whose turnover (excluding other income) does not exceed rupees five hundred crores in the immediately preceding accounting year.

**Ans: (b)**

C

# CHAPTER 4.1: AS 1- DISCLOSURE OF ACCOUNTING POLICIES

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Fundamental Accounting Assumptions<br>• Nature of Accounting Policies<br>• Areas with Different Accounting Policies<br>• Considerations in selecting Accounting Policies | LDR Questions<br>Q 5 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

| Fundamental Accounting Assumptions | Accounting Policies |
|---|---|
| These assumptions underlie the preparation and presentation of financial statements. | 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. |

**Considerations in selection of Accounting policies**

| | |
|---|---|
| Prudence | • In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. |
| 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 |
| Materiality | • Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the users of the financial statements. |
| | • 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. |

**Fundamental Accounting Assumptions**

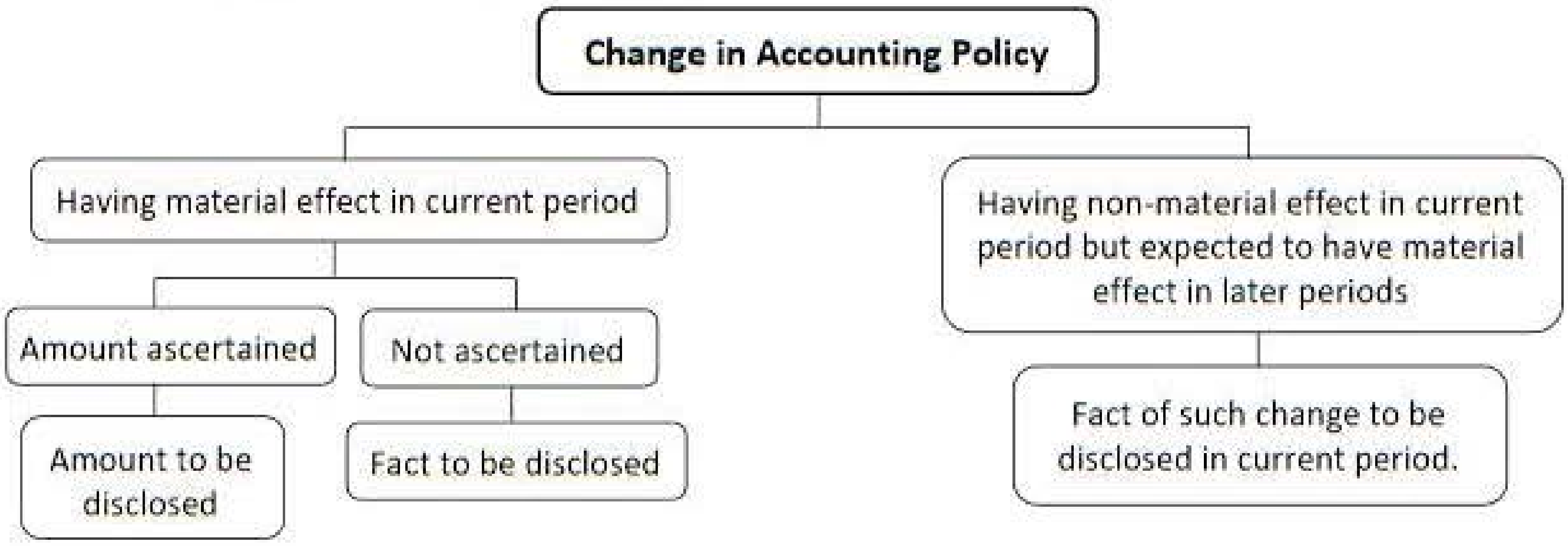
| | |
|---|---|
| Going Concern | • The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable Future. |
| Consistency | • Accounting policies are considered to be consistent from one period to another. |
| Accrual | • Revenues and costs are accrued, that is, recognised as they are earned or incurred and recorded in the financial statements of the periods to which they relate. |

| | | |
|---|---|---|
| **Fundamental Accounting Assumptions** | If followed | Not required to be disclosed |
| | If not followed | Specific disclosure required in financial statements. |

### Disclosure of Accounting Policies

- All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
- Disclosure should form part of the financial statements.
- Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

### Disclosure of Changes in Accounting Policies




## <u>Question & Answers</u>

### Question 1

**The draft results of Surya Ltd. for the year ended 31st March, 2020, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of Rs. 10 crores. The board in consultation with the managing director, decided to value year-end inventory at works cost (Rs. 50 crores) instead of the hitherto method of valuation of inventory at prime cost (Rs. 30 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 2019-2020. *(RTP May '21)***

**Answer 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.

**Notes on Accounts:**

"During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at Rs. 50 crores and the profit for the year is increased by Rs. 20 crores."

### Question 2

**In the books of Rani Ltd., closing inventory as on 31.03.2020 amounts to ₹1,75,000 (valued based on FIFO method). The Company decides to change from FIFO method to weighted average method for ascertaining the costs of inventory from the year 2019-20. On the basis of weighted average method, closing inventory as on 31.03.2020 amounts to ₹1,59,000. Realizable value of the inventory as on 31.03.2020 amounts to ₹2,07,000. Discuss disclosure requirements of change in accounting policy as per AS 1. *(MTP Nov '21, 5 Marks, MTP Oct'18 5 Marks, RTP May 23, PYP 5 Marks Dec'21,SM)***

**Answer 2**

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 Rani 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 realizable value. Since net realizable 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. 2019-20, 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 (1,75,000 – 1,59,000)."

## Question 3

**Wiwitzu Ltd. had made a rights issue of shares in 2017. In the offer document to its members, it had projected a surplus of Rs. 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 Rs. 10 crores. The board in consultation with the managing director, decided 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 Rs. 600 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** ***(MTP Apr'19, Aug'18, Oct'22 5 Marks)***

**Answer 3**

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

**Notes on Accounts:**

So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by Rs. 12 crores than would have been the case if the old policy were to continue.

## Question 4

**You are required to comment on the following cases as per the provisions of Accounting Standard-1 'Disclosure of Accounting Policies':**

**(1) Bee Limited has not complied with AS-2 "Valuation of inventories" and the same is disclosed in the Notes on Accounts. Management is of the view that the financial statements give a true and fair view as non-compliance with AS-2 is disclosed.**

**(2) Cee Limited sold its Office Building for ₹ 10,00,000 on 1st March, 2023. The buyer has paid the full amount and taken possession of the building. The book value of the Office Building is ₹ 4,00,000. On 31st 2023, documentation and legal formalities are pending. The company has not recorded the disposal, and the amount received is shown as an advance.**

**(3) Dee Limited has prepared its accounts on cash basis and the same is not disclosed.**

**(4) Jee Limited disclosed significant accounting policies adopted in the preparation of financial statements, in the Directors' Report.** ***(PYP 5 Marks May '23)***

**Answer 4**

(1) As per AS-1 disclosure of accounting policies is not a remedy for wrong or inappropriate treatment in accounting. In the given case the financial statement does not give a true and fair view as they are not in compliance with AS-2.

(2) Considering the substance over form as per AS-1, documentation and legal formalities represent the form of the transaction, although the legal title has not been transferred, the economic reality and substance are that the rights and beneficial interest in the Office Building have been transferred. Therefore, recording of acquisition/ disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

(3) Accrual is a fundamental accounting assumption. If it is not followed by the company, the facts should be disclosed under AS-1. Hence the company should disclose the fact that the cash basis of accounting has been followed in the notes on accounts.

(4) The practice followed by the company is not correct. It should be disclosed as part of financial statements (The director's report is not part of financial statements).

## Question 5

LDR

**State whether the following statements are 'True' or 'False' in line with the provisions of AS 1. Also give reason for your answer.**

**(i) Certain fundamental accounting assumptions underline the preparation and presentation of financial statements. They are usually specifically stated because their acceptance and use are not assumed.**

**(ii) If fundamental accounting assumptions are not followed in presentation and preparation of financial statements, a specific disclosure is not required.**

**(iii) All significant accounting policies adopted in the preparation and presentation of financial statements should form part of the financial statements.**

**(iv) Any change in an accounting policy, which has a material effect should be disclosed. Where the amount by which any item in the financial statements is affected by such change is not ascertainable, wholly or in part, the fact need not to be indicated.**

**(v) There is no single list of accounting policies which are applicable to all circumstances.**

***(MTP 5 Marks April 21, Oct 19, Mar 22, May'20 & Oct '23, RTP 5 Marks May 20, PYP 5 Marks May '22, SM)***

### Answer 5

(i) False; As per AS 1 "Disclosure of Accounting Policies", 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.

(ii) False; As per AS 1, if the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

(iii) True; 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. The disclosure of the significant accounting policies as such should form part of the financial statements and they should be disclosed at one place.

(iv) False; 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. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

(v) True; As per AS 1, 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.

## Question 6

**Discuss Disclosure requirements in following cases as per AS 1.**

**(i) Accountant of A Ltd. charges a probable loss of losing a suit in books of accounts and also disclosed the same fact in financial statements. The probability of losing the suit is 25%.**

**(ii) Accountant of A Ltd. capitalized all the revenue expenses of repair and maintenance during the year to Plant & Machinery and is also disclosing the same as company policy in financial statements.**

**(iii) A Ltd. has followed accrual basis of accounting since incorporation. The chief accountant also disclosed this fact in financial statements.**

**(iv) A Ltd. was providing for after sales expenses @ 2% of sales for covering expenses during the warranty period. Now A Ltd. observes that actual after sales expenses were much less as compared to provision because of better technology used in manufacturing of the products. Now, the Board of A Ltd. decides to account for these expenses as and when they occur. Sales during the period are ₹ 50 crores.** ***(PYP 5 Marks Nov'23)***

### Answer 6

(i) In this case, accountant of company created a provision for damages of probability of losing a suit by a charge against profits. Unless the probability of losing the suit is more than probability of not losing it, there should not be any creation of provision for such probable losses. So there is no need to charge such loss against profit and disclosing the same in financial statements.

(ii) Repairs and maintenance are revenue expenditure and should not be added to the value of assets, as these expenses do not increase the capacity of asset. Hence such expenses should be charged to profit & loss statement.

Further the chief accountant also disclosed its policy of adding repairs to value of assets by way of notes to accounts. As per AS 1 disclosure is not a method to correct the wrong treatments. So the contention of chief accountant is wrong.

(iii) Accrual is one of the Fundamental accounting assumptions. If fundamental accounting assumptions are followed properly then no specific disclosure is required.

Disclosure is required only when there is deviation and the company is not following fundamental accounting assumptions. So the company need not disclose this in financial statements.

(iv) 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. Accordingly, the notes on accounts should properly disclose the change and its effect.

Note: So far, the company has been providing 2% of sales for meeting after sales expenses during the warranty period. Now the company has improved the quality of its products with better technology and has been observing that actual expenses are very less than the provision, 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 ₹1 crore than would have been the case if the old policy were to continue.

## Question 7

**ABC Ltd. was making provision for non-moving inventories based on no issues for the last 12 months up to 31.3.2023.**

**The company wants to provide during the year ending 31.3.2024 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?** ***(RTP Jan'25, MTP 5 Marks March '21, MTP 5 Marks April '22 & MTP 5 Marks April '23) (PYP Nov '18, 5 Marks, PYP 5 Marks Dec'21) (Same concept different figures-( MTP 5 Marks Mar'23, RTP May'20 & Nov '23)***

**Answer 7**

The decision of making provision for non-moving inventories on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving inventories should be made. The method of estimating the amount of provision may be changed in case a more prudent estimate can be made. In the given case, considering the total value of inventory, the change in the amount of required provision of non-moving inventory from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2023-24:

"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."

## Multiple Choice Questions (MCQs)

1. **Which of the following is NOT a major consideration in selection and application of accounting policies?** ***(SM)***
   (a) Prudence
   (b) Comparability
   (c) Materiality
   (d) Substance over form

**Ans: (b)**

**2. Adoption of different accounting policies by different companies operating in the same industry affects which of the qualitative characteristics the most? *(SM)***

(a) Comparability
(b) Relevance
(c) Faithful representation
(d) Reliability

**Ans: (a)**

**3. Which of the following statement would not be correct in relation to disclosures to be made in the financial statements after making any change in an accounting policy? *(SM)***

(a) Any change in an accounting policy which has a material effect should be disclosed.
(b) The amount by which any item in the financial statements is affected by such change should be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
(c) 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.
(d) If a change is made in an accounting policy which has material effect on the financial statements for the current period and is reasonably expected to have a material effect in later periods, the fact of such change shouldbe appropriately disclosed only in the later periods i.e. year(s) next to the year in which the change is adopted.

**Ans: (d)**

# CHAPTER 4.2: AS 3- CASH FLOW STATEMENT

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Definition of cash and cash equivalents<br>• Presentation of cash flow statement<br>• Reporting cash flows from operating activities<br>• Reporting cash flows from investing and financing activities<br>• Reporting cash flows on a net basis<br>• Foreign currency cash flows<br>• Extraordinary items<br>• Interest and dividends<br>• Taxes on income | LDR<br>**LDR Questions**<br>**Q 12** |

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Operating Activities**

These are the principal revenue-producing activities of the entity other than investing or financing activities

Reporting

- Under direct method
- Under indirect method

Examples:

- Cash receipts from sales and services
- Cash receipts from royalties, fees, and commissions
- Cash payments to suppliers
- Cash payments to employees
- Cash flows of insurance entities for premiums, claims, and policy benefits
- Cash payments or refunds of income taxes (unless tied to financing/investing)
- Cash flows from trading in futures, forwards, options, and swaps
- Cash flows from buying/selling trading securities
- Cash advances and loans by financial institutions

**Investing Activities**

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Cash flows arising from investing activities represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

These are examples of investing cash flows:

- Payments to acquire fixed assets (including intangibles, R&D, and self-constructed assets)
- Receipts from sales of property, plant, equipment, and long-term assets
- Payments to acquire equity/debt instruments or joint venture interests (excluding cash equivalents or trading assets)
- Receipts from sales of equity/debt instruments or joint venture interests (excluding cash equivalents or trading assets)
- Advances and loans made to other parties (excluding financial institutions)
- Receipts from the repayment of advances and loans (excluding financial institutions)
- Payments for futures, forwards, options, and swaps (unless for trading or financing)
- Receipts from futures, forwards, options, and swaps (unless for trading or financing)

| Financing Activities |
|---|
| Financing activities are activities that result in changes in the size and composition of the owner's capital and borrowings of the entity. Cash Flows arising from investing activities useful in predicting claims on future cash flows by providers of funds to the entity. |
| **Examples**<br>• cash proceeds from issuing shares or other equity instruments;<br>• cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;<br>• cash repayments of amounts borrowed. |

**Foreign currency cash Flows** → Arising from transactions in a foreign currency → Recorded in an enterprise's reporting currency → Foreign currency amount × Exchange rate between the reporting currency and the foreign currency at the date of the cash flow

**Important Points**

| | | |
|---|---|---|
| 1. | **Unrealised gains and losses arising from changes in foreign currency exchange rates** | are not cash flows. |
| 2. | **The effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency** | is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period.<br>is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at end of period exchange rates. |



## Question & Answers

### Question 1

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

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

**(1) to suppliers**

**(2) to employees**

**(3) to its subsidiaries companies**

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

**(iii) Dividend paid for the year**

**(iv) Insurance claim received against loss of property, plant and equipment by fire.**

**Discuss in the context of AS 3 'Cash Flow Statement'. *(RTP Sep'24) (SM)***

**Answer 1**

**Treatment as per AS 3 'Cash Flow Statement'**

(i) Loans and advances given and interest earned

(1) to suppliers -*Cash flows from operating activities*

(2) to employees -*Cash flows from operating activities*

(3) to its subsidiary companies -*Cash flows from investing activities*

(ii) Investment made in subsidiary company and dividend received -*Cash flows from investing activities*

(iii) Dividend paid for the year -*Cash flows from financing activities*

(iv) Insurance claim received against loss of property, plant and equipment by fire- Extraordinary Items to be shown as a separate head under -*Cash flow from Investing Activities*

### Question 2

**Classify the following activities as**

**(i) Operating Activities, (ii) Investing activities, (iii) Financial activities and (iv) Cash Equivalents.**

| Sr No | Particulars | Sr No | Particulars | Sr No | Particulars |
|---|---|---|---|---|---|
| 1 | Cash receipts from Trade Receivables | 11 | Proceeds from long-term borrowings. | 22 | Purchase of Machinery. |
| 2 | Highly liquid Marketable Securities without risk of change in value | 12 | Proceeds from Trade receivables. | 23 | Proceeds from issuance of equity share capital |
| 3 | Purchase of investment | 13 | Trading Commission received. | 24 | Cash Sales. |
| 4 | Proceeds from long term borrowings | 14 | Redemption of Preference Shares. | 25 | Proceeds from long-term borrowings. |
| 5 | Wages and Salaries paid | 15 | Proceeds from sale of investment | 26 | Proceeds from Trade receivables. |
| 6 | Bank overdraft | 16 | Interim Dividend paid on equity shares. | 27 | Cash receipts from Trade receivables. |
| 7 | Purchase of Goodwill | 17 | Interest received on debentures held as investment. | 28 | Trading Commission received. |
| 8 | Interim dividend paid on equity shares | 18 | Dividend received on shares held as investments. | 29 | Purchase of investment. |
| 9 | Short term Deposits | 19 | Rent received on property held as investment. | 30 | Redemption of Preference Shares. |
| 10 | Underwriting commission paid | 20 | Dividend paid on Preference shares. | 31 | Cash Purchases |
| | | 21 | Marketable Securities | | |

*(MTP 5 Marks, Sep 22, RTP Jan'25) (PYP May '18, 5 Marks) (RTP May 20) (MTP 5 Marks Oct '18)*

**Answer 2**

(a) Operating Activities: Items 1, 5,12 and 13, 24,26,27,28,31
(b) Investing Activities: Items 3,7,9 ,15, 17, 18 ,19 ,22 and 29
(c) Financing Activities: Items 4,6,8, 10,11,14,16 ,20 ,23,25,30
(d) Cash Equivalent: 2 and 21.

## Question 3

**Ridgeway Limited, a Non-Financial company has the following activities:**

**(i) Dividend paid for the year.**
**(ii) TDS on interest income earned on investments made.**
**(iii) Loans and advances given to suppliers and interest earned from them.**
**(iv) Deposit with bank for a term of two years.**
**(v) Highly liquid Marketable Securities (without risk of change in value).**
**(vi) Investments made and dividends earned on them.**
**(vii) Insurance claims received against loss of stock or loss of profits.**
**(viii) Loans and advances given to subsidiaries and interest earned from them.**
**(ix) Issue of Bonus Shares.**
**(x) Term loan repaid.**

**You are required to classify the above activities in Cash Flow Statement as per 'AS-3'.**
***(PYP 5 Marks Nov '22)***

**Answer 3**

| No. | | Activities |
|---|---|---|
| (i) | Dividend paid for the year | Financing |
| (ii) | TDS on interest income earned on investments made | Investing |

| | | |
|---|---|---|
| (iii) | Loans and advances given to suppliers and interest earned from them | Operating |
| (iv) | Deposit with bank for a term of two years | Investing |
| (v) | Highly liquid Marketable Securities (without risk of change in value) | Cash Equivalent |
| (vi) | Investments made and dividends earned on them | Investing |
| (vii) | Insurance claims received against loss of stock | Operating |
| | or loss of profits | |
| (viii) | Loans and advances given to subsidiaries and interest earned from them | Investing |
| (ix) | Issue of Bonus Shares | No Cash Inflow or Cash outflow |
| (x) | Term Loan repaid | Financing |

## Question 4

**From the following information, prepare the Cash Flow from Financing activities as per AS 3 'Cash Flow Statements' as the accountant of XYZ Limited is not able to decide and seeks your advice:**

**(i) Received ₹ 4,00,000 as redemption of short-term deposit**
**(ii) Proceeds of ₹ 20,00,000 from issuance of equity share capital**
**(iii) Received interest of ₹ 70,000 on Govt. bonds.**
**(iv) An amount of ₹ 13,00,000 incurred for purchase of goodwill**
**(v) Proceeds of ₹ 5,00,000 from sale of patent.**
**(vi) Proceeds of ₹ 12,00,000 from long term borrowing.**
**(vii) Amount paid for redemption of debentures of ₹ 22,00,000**
**(viii) Underwriting commission of ₹ 40,000 paid on issue of equity share capital**
**(ix) Interest of ₹ 1,44,000 paid on long-term borrowing. *(MTP 5 Marks Oct '21)***

**Answer 4**

**Statement showing Cash Flow from Financing Activities**

| | | ₹ |
|---|---|---|
| Cash inflow from financing activity | | |
| Proceeds from issuance of equity share capital | 20,00,000 | |
| Proceeds from long term borrowings | 12,00,000 | |
| Total cash inflow from financing activity | | 32,00,000 |
| Less: Cash outflow from financing activity | | |
| Amount paid for redemption of debentures | 22,00,000 | |
| Underwriting commission paid | 40,000 | |
| Interest paid on long-term borrowings | 1,44,000 | (23,84,000) |
| Net cash inflow from financing activity | | 8,16,000 |

## Question 5

**How will you disclose following items while preparing Cash Flow Statement of Gagan Ltd. as per AS-3 for the year ended 31st March, 2022? *(MTP 5 Marks March '23, SM)***

| | | |
|---|---|---|
| (i) | 10% Debentures issued: | As on 01-04-2021 ₹ 1,10,000 |
| | | As on 31-03-2022 ₹ 77,000 |
| (ii) | Debentures were redeemed at 5% premium at the end of the year. Premium was charged to the Profit & Loss Account for the year. | |
| (iii) | Unpaid Interest on Debentures | As on 01-04-2021 ₹ 275 |
| | | As on 31-03-2022 ₹ 1,175 |
| (iv) | Debtors of ₹ 36,000 were written off against the Provision for Doubtful Debts A/c during the year. | |
| (v) | 10% Bonds (Investments): | As on 01-04-2021 ₹ 3,50,000 |
| | | As on 31-03-2022 ₹ 3,50,000 |
| (vi) | Accrued Interest on Investments: | As on 31-03-2022 ₹ 10,500 |

**Answer 5**

**Cash Flow Statement of Gagan Ltd. for the year ended March 31, 2022**

| | | |
|---|---|---|
| **A** | **Cash Flow from Operating Activities** | |
| | Net Profit as per Profit & Loss A/c | -------- |
| | Add: Premium on Redemption of Debentures | 1,650 |
| | Add: Interest on 10% Debentures | 11,000 |
| | Less: Interest on 10% Investments | (35,000) |
| **B** | **Cash Flow from Investing Activities** | |
| | Interest on Investments [35,000-10,500] | 24,500 |
| **C** | **Cash Flow from Financing Activities** | |
| | Interest on Debentures paid [11,000 - (1,175 - 275)] | (10,100) |
| | Redemption of Debentures [(1,10,000 - 77,000) at 5% premium] | (34,650) |

**Note**: Debtors written off against provision for doubtful debts does not require any further adjustment in Cash Flow Statement.

## Question 6

**Prepare cash flow statement of Gama Limited for the year ended 31st March, 2021 in accordance with AS-3(Revised) from the following cash account summary: *(PYP July'21, 5 Marks)***

**Cash summary Account**

| Inflows | ₹ ('000) | Outflows | ₹ ('000) |
|---|---|---|---|
| Opening Balance | 945 | Payment to suppliers | 54,918 |
| Receipts from Customers | 74,682 | Purchase of Investments | 351 |
| Sale of Investments (Cost ₹ 4,05,000) | 459 | Property, plant and equipment acquired | 6,210 |
| Issue of Shares | 8,100 | Wages and salaries | 1,863 |
| Sale of Property, Plant and equipment | 3,456 | Payment of Overheads | 3,105 |
| | | Taxation | 6,561 |
| | | Dividends | 2,160 |
| | | Repayment of Bank Overdraft | 6,750 |
| | | Interest paid on Bank Overdraft | 1,350 |
| | | Closing Balance | 4,374 |
| | 87,642 | | 87,642 |

**Answer 6**

**Gama Limited Cash Flow Statement for the Year Ended 31st March 2021**

| Particulars | Amount (₹'000) | Amount (₹'000) |
|---|---|---|
| **Cash flow from Operating Activities:** | | |
| Cash receipts from customers | 74,682 | |
| Cash payments to suppliers | (54,918) | |
| Cash payments for wages & salaries | (1,863) | |
| Cash payments of overheads | (3,105) | |
| Cash Generated from Operations | 14,796 | |
| Payment of Taxation | (6,561) | |
| **Net Cash from Operating Activities** | | 8,235 |
| **Cash Flow from Investing Activities:** | | |
| Proceeds from sale of investments | 459 | |
| Proceeds from sale of Property, Plant and Equipment | 3,456 | |
| Purchase of Investments | (351) | |

| | | |
|---|---|---|
| Purchase of Property, Plant and Equipment | (6,210) | |
| **Net Cash Used in Investing Activities** | | (2,646) |
| **Cash Flow from Financing Activities:** | | |
| Proceeds from issue of shares | 8,100 | |
| Payment of Dividend | (2,160) | |
| Repayment of Bank Overdraft | (6,750) | |
| Interest paid on Bank Overdraft | (1,350) | |
| **Net Cash Used in Financing Activities** | | (2,160) |
| **Net Increase in Cash & Cash Equivalent** | | 3,429 |
| **Cash and Cash Equivalent in the Beginning of the year** | | 945 |
| **Cash and Cash Equivalent in the end of the year** | | 4374 |

## Question 7

**Following are the extracts from the Balance Sheet of ABC Ltd.**

| **Liabilities** | **31.3.2020 (₹)** | **31.3.2021 (₹)** |
|---|---|---|
| **Equity Share Capital** | **25,00,0000** | **35,60,000** |
| **10% Preference Share Capital** | **7,00,000** | **6,00,000** |
| **Securities Premium Account** | **5,00,000** | **5,50,000** |
| **Profit & Loss A/c** | **20,00,000** | **28,00,000** |

**Equity Share Capital for the year ended 31st March, 2021 includes ₹ 60,000 of equity shares issued to Grey Ltd. at par for supply of Machinery of ₹ 60,000. Profit & Loss account on 31st March, 2021 includes ₹ 50,000 of dividend received on Equity shares invested in X Ltd. Show how the related items will appear in the Cash Flow Statement of ABC Ltd. as per AS-3 (Revised)*(PYP 5 Marks, Dec '21)***

**Answer 7**

**The related items given in the question will appear in the Cash Flow Statement of ABC Limited for the year ended 31st March, 2021 as follows:**

| | | ₹ | ₹ |
|---|---|---|---|
| Cash flows from operating activities | | | |
| Closing Balance as per Profit and Loss Account | | 28,00,000 | |
| Less: Opening Balance as per Profit and Loss Account | | (20,00,000) | |
| | | 8,00,000 | |
| Less: Dividend received | | (50,000) | 7,50,000 |
| Cash flows from investing activities | | | |
| Dividend received | | | 50,000 |
| Cash flows from financing activities | | | |
| Proceeds from issuance of share capital<br>Equity shares issued for cash | ₹ 10,00,000 | | |
| Proceeds from securities premium<br>(₹ 5,50,000 – 5,00,000) | ₹50,000 | 10,50,000 | |
| Less: Redemption of Preference shares<br>(₹ 7,00,000 – ₹ 6,00,000) | | (1,00,000) | 9,50,000 |

Note:

1. Machinery acquired by issue of shares does not amount to cash outflow, hence also not considered in the cash flow statement.
2. ABC Ltd. has been considered as a non-financial company in the given answer.

## Question 8

**The following information is provided by Wivtzu Limited, for the year ended 31st March, 2022:**

**(i) Net profit before taking into account income tax and income from law suits but after taking into account the following items was ₹ 40 lakhs.**

(ii) Depreciation on Fixed Assets ₹ 10 lakhs.
(iii) Discount on issue of Debentures written of ₹ 60,000.
(iv) Interest on Debentures paid ₹ 7,00,000.
(v) Book value of investments ₹ 6 lakhs (Sale of Investments for ₹ 6,40,000).
(vi) Interest received on investments ₹ 1,20,000.
(vii) Compensation received ₹ 1,80,000 by the company in a suit filed.
(viii) Income tax paid ₹ 21,00,000
(ix) Current assets and current liabilities in the beginning and at the end of the year were as detailed below:

| | As on 31.3.2021 ₹ | As on 31.3.2022 ₹ |
|---|---|---|
| Stock | 24,00,000 | 26,36,000 |
| Sundry Debtors | 4,16,000 | 4,26,200 |
| Cash in hand | 3,92,600 | 70,600 |
| Bills Receivable | 1,00,000 | 80,000 |
| Bills Payable | 90,000 | 80,000 |
| Sundry Creditors | 3,32,000 | 3,42,600 |
| Outstanding Expenses | 1,50,000 | 1,63,600 |

You are required to prepare Cash Flow Statement from Operating Activities in accordance with AS-3 (revised) using the indirect method for the year ended 31st March,2022. *(PYP 5 Marks May'22)*

**Answer 8**

**Wivtzu Ltd.**

**Cash Flow Statement (from Operating Activities) for the year ended 31st March, 2022**

| | ₹ | ₹ |
|---|---|---|
| Cash flow from Operating Activities | | |
| Net profit before income tax and extraordinary items: | | 40,00,000 |
| Adjustments for: | | |
| Depreciation on Property, plant and equipment | 10,00,000 | |
| Discount on issue of debentures | 60,000 | |
| Interest on debentures paid | 7,00,000 | |
| Interest on investments received | (1,20,000) | |
| Profit on sale of investments | (40,000) | 16,00,000 |
| Operating profit before working capital changes | | 56,00,000 |
| Adjustments for: | | |
| Increase in inventory | (2,36,000) | |
| Increase in Sundry Debtors | (10,200) | |
| Decrease in Bills receivables | 20,000 | |
| Increase in Sundry Creditors | 10,600 | |
| Increase in Bills payables | (10,000) | |
| Increase in outstanding expenses | 13,600 | (2,12,000) |
| Cash generated from operations | | 53,88,000 |
| Income tax paid | | (21,00,000) |
| Cash flow from ordinary items | | 32,88,000 |
| Cash flow from extraordinary items: | | |
| Compensation received in a suit filed | | 1,80,000 |
| Net cash flow from operating activities | | 34,68,000 |

## Question 9

Following is the cash flow abstract of Wivtzu Ltd. for the year ended 31st March, 2021:

Cash Flow (Abstract)

| Inflows | Rs. | Outflows | Rs. |
|---|---|---|---|
| Opening cash and bank balance | 80,000 | Payment for Account Payables | 90,000 |

| | | | |
|---|---|---|---|
| Share capital – shares issued | 5,00,000 | Salaries and wages | 25,000 |
| Collection from Trade Receivables | 3,50,000 | Payment of overheads | 15,000 |
| Sale of Machinery | 70,000 | Machinery acquired | 4,00,000 |
| | | Debentures redeemed | 50,000 |
| | | Bank loan repaid | 2,50,000 |
| | | Tax paid | 1,55,000 |
| | | Closing cash and bank balance | 15,000 |
| | 10,00,000 | | 10,00,000 |

**Prepare Cash Flow Statement for the year ended 31st March, 2021 in accordance with AS 3.**
***(MTP 5 Marks April 21, Mar 22, SM)***

**Answer 9**

**Cash Flow Statement for the year ended 31.3.2021**

| | Rs. | Rs. |
|---|---|---|
| **Cash flow from operating activities** | | |
| Cash received on account of trade receivables | 3,50,000 | |
| Cash paid on account of trade payables | (90,000) | |
| Cash paid to employees (salaries and wages) | (25,000) | |
| Other cash payments (overheads) | (15,000) | |
| Cash generated from operations | 2,20,000 | |
| Income tax paid | (1,55,000) | |
| Net cash generated from operating activities | | 65,000 |
| **Cash flow from investing activities** | | |
| Payment for purchase of machinery | (4,00,000) | |
| Proceeds from sale of machinery | 70,000 | |
| Net cash used in investment activities | | (3,30,000) |
| **Cash flow from financing activities** | | |
| Proceeds from issue of share capital | 5,00,000 | |
| Bank loan repaid | (2,50,000) | |
| Debentures redeemed | (50,000) | |
| Net cash used in financing activities | | 2,00,000 |
| Net decrease in cash and cash equivalents | | (65,000) |
| Cash and cash equivalents at the beginning of the year | | 80,000 |
| Cash and cash equivalents at the end of the year | | 15,000 |

## Question 10

**Prepare cash flow from investing activities as per AS 3 of M/s Subham Creative Limited for year ended 31.3.2019.**

| Particulars | Amount (Rs. ) |
|---|---|
| Machinery acquired by issue of shares at face value | 2,00,000 |
| Claim received for loss of machinery in earthquake | 55,000 |
| Unsecured loans given to associates | 5,00,000 |
| Interest on loan received form associate company | 70,000 |
| Pre-acquisition dividend received on investment made | 52,600 |
| Debenture interest paid | 1,45,200 |
| Term loan repaid | 4,50,000 |
| Interest received on investment (TDS of Rs. 8,200 was deducted on the above interest) | 73,800 |
| Purchased debentures of X Ltd., on 1st December, 2018 which are redeemable within 3 months | 3,00,000 |

| | |
|---|---|
| Book value of plant & machinery sold (loss incurred Rs. 9,600) | 90,000 |

(PYP Nov.'19,5 Marks, SM) (Same concept lesser adjustments- MTP 4 Marks March 21, MTP 5 Marks April 22 & Oct '23)

**Answer 10**

**Cash Flow Statement from Investing Activities of Subham Creative Limited for the year ended 31-03-2019**

| Cash generated from investing activities | Rs. | Rs. |
|---|---|---|
| Interest on loan received | 70,000 | |
| Pre-acquisition dividend received on investment made | 52,600 | |
| Unsecured loans given to subsidiaries | (5,00,000) | |
| Interest received on investments (gross value) | 82,000 | |
| TDS deducted on interest | (8,200) | |
| Sale of Plant & Machinery ₹ (90,000 – 9,600) | 80,400 | |
| Cash used in investing activities (before extra-ordinary item) | | (2,23,200) |
| Extraordinary claim received for loss of machinery | | 55,000 |
| Net cash used in investing activities (after extra-ordinary item) | | (1,68,200) |

**Note:**

1. Debenture interest paid and Term Loan repaid are financing activities and therefore not considered for preparing cash flow from investing activities.
2. Machinery acquired by issue of shares does not amount to cash outflow, hence also not considered in the above cash flow statement.
3. The investments made in debentures are for short-term, it will be treated as 'cash equivalent' and will not be considered as outflow in cash flow statement.

## Question 11

**The summarized Balance Sheets of Flora Limited for the year ended 31st March, 2022 and 31st March, 2023 are as below:**

| Assets | 31/03/2023 (₹) | 31/03/2022 (₹) |
|---|---|---|
| Goodwill | 15,000 | 28,000 |
| Land | 5,75,000 | 6,00,000 |
| Furniture and Fixtures | 48,000 | 44,000 |
| Vehicles | 22,000 | 28,000 |
| Office Equipment | 21,000 | - |
| Long-term Investments | 60,000 | 1,10,000 |
| Stock-in-hand | 96,000 | 88,000 |
| Bills Receivables | 18,150 | 14,500 |
| Trade Receivables | 46,000 | 52,000 |
| Cash and Bank Balances | 1,29,850 | 34,500 |
| Total | 10,31,000 | 9,99,000 |

| Liabilities | 31/03/2023 (₹) | 31/03/2022 (₹) |
|---|---|---|
| Equity Shares Capital | 6,80,000 | 5,00,000 |
| General Reserves | 90,000 | 60,000 |
| Profit and Loss Account | 93,000 | 52,000 |
| Capital Reserve | 75,000 | - |
| 8% Debentures of ₹ 100 each | - | 3,00,000 |
| Loan from Mr. Andrew | - | 15,000 |
| Bills Payables | 11,000 | 13,000 |
| Trade Payables | 49,000 | 45,000 |

| | | |
|---|---|---|
| Creditors for Equipment | 10,500 | - |
| Outstanding Expenses | 4,500 | 3,000 |
| Provision for Taxation | 18,000 | 11,000 |
| Total | 10,31,000 | 9,99,000 |

**Additional Information:**

i) On 1st April, 2022, one of the vehicles was sold for ₹ 3,000. No new purchases were made during the year.

ii) A part of the total land was sold for ₹ 1,25,000 (Cost ₹ 1,00,000) and the balance land was revalued. Capital reserve consists of profit on revaluation of balance land. No new purchases were made during the year.

iii) Depreciation provided during the year-
- Furniture and Fixtures ₹ 5,000
- Vehicles ₹ 2,200

iv) Interim dividend of 5,000 was paid during the year.

v) Provision for taxation for the year 2022-2023 was ₹ 16,000.

vi) 8% Debentures were redeemed at par after half year interest payment on 30th September, 2022.

vii) Part of the long-term investments were sold at a profit of 8,000.

viii) Interest income received during the year on long-term investment was 6,500.

You are required to prepare Cash Flow Statement from Operating Activities for the year ended 31st March, 2023 using indirect method. (All workings should form part of the answer)

*(PYP 10 Marks May '23)*

**Answer 11**

**Cash Flow Statement of Flora Limited from Operating Activities For the year ended 31st March, 2023**

| | ₹ | ₹ |
|---|---|---|
| Net profit before taxation (W.N.1) | | 92,000 |
| Adjustment: Depreciation on Furniture & Fixtures | 5,000 | |
| Depreciation on Vehicles | 2,200 | |
| Profit on sale of land (₹ 125000 - ₹ 100000) | (25,000) | |
| Loss on sale (Vehicle) | 800 | |
| Profit on sale of long-term investments | (8,000) | |
| Interest received | (6,500) | |
| Interest on debentures | 12,000 | |
| Goodwill written off | 13,000 | (6,500) |
| Operating profit before working capital changes | | 85,500 |
| Increase in Stock in Hand | (8,000) | |
| Increase in Bills Receivables | (3,650) | |
| Decrease in Trade Receivables | 6,000 | |
| Decrease in Bills payable | (2,000) | |
| Increase in Trade Payables | 4,000 | |
| Increase in outstanding expenses | 1,500 | (2,150) |
| Cash generated from Operations | | 83,350 |
| Less: Income taxes paid | | 9,000 |
| Cash flow from Operating activities | | 74,350 |

**Alternative presentation:**

**Cash Flow Statement of Flora Limited from Operating Activities For the year ended 31st March, 2023**

| | | ₹ |
|---|---|---|
| Net profit before taxation (W.N. 1) | | 92,000 |

| | | |
|---|---|---|
| Adjustment: Depreciation on Furniture & fixtures | 5,000 | |
| Depreciation on Vehicles | 2,200 | |
| Profit on sale of land | (25,000) | |
| Loss on sale (Vehicle) | 800 | |
| Profit on sale of long- term investments | (8,000) | |
| Interest received | (6,500) | |
| Interest on debentures | 12,000 | |
| Goodwill written off | 13,000 | (6,500) |
| Operating profit before working capital changes | | 85,500 |
| Increase in inventory | (8,000) | |
| Decrease in Trade receivables* | 2,350 | |
| Increase in Trade payables** | 2,000 | |
| Increase in outstanding expenses | 1,500 | (2,150) |
| Cash generated from Operations | | 83,350 |
| Less: Income taxes paid | | 9,000 |
| Cash flow from Operating activities | | 74,350 |

* [(18,150 +46,000) - (14,500 + 52,000)] ** [(11,000 49,000) - (13,000+45,000)]

Working Notes:

**1. Net Profit before Taxation**

| | |
|---|---|
| Increases in Profit and Loss A/c (93,000-52,000) | 41,000 |
| Increases in General Reserve (90,000-60,000) | 30,000 |
| Interim dividend Paid | 5,000 |
| Transfer – provision for Taxation | 16,000 |
| Increase in retained earnings(Net Profit before Taxation) | 92,000 |

**2. Provision for Taxation Account**

| | ₹ | | ₹ |
|---|---|---|---|
| To Bank (Balancing figure) | 9,000 | By Balance b/d | 11,000 |
| To Balance c/d | 18,000 | By Profit and loss account | 16,000 |
| | 27,000 | | 27,000 |

**3. Vehicles Account**

| **Particulars** | **(₹)** |
|---|---|
| Opening Balance | 28,000 |
| Less: Depreciation | (2,200) |
| Less: Closing Balance | (22,000) |
| Book value of vehicle sold | 3,800 |
| Less: Sale Value | (3,000) |
| Loss on sale of Vehicle | 800 |

## Question 12 LDR

**On the basis of the following information prepare a Cash Flow Statement for the year ended 31st March, 2023 (Using direct method):**

**(i) Total sales for the year were ₹ 796 crores out of which cash sales amounted to ₹ 524 crores.**

**(ii) Receipts from credit customers during the year, totalled ₹ 268 crores.**

**(iii) Purchases for the year amounted to ₹ 440 crores out of which credit purchase was 80%.**

**Balance in creditors as on 1.4.2022 ₹ 168 crores**

**31.3.2023 ₹ 184 crores**

(iv) Suppliers of other consumables and services were paid ₹ 38 crores in cash.
(v) Employees of the enterprises were paid 40 crores in cash.
(vi) Fully paid 9% Preference shares of the face value of ₹ 64 crores were redeemed. Equity shares of the face value of ₹ 40 crores were allotted as fully paid up at premium of 20%.
(vii) 10% Debentures of ₹ 40 crores at a premium of 10% were redeemed. Debenture holders were issued equity shares in lieu of their debentures.
(viii) ₹ 52 crores were paid by way of income tax.
(ix) A new machinery costing ₹ 50 crores was purchased in part exchange of an old machinery. The book value of the old machinery was ₹ 26 crores. Through the negotiations, the vendor agreed to take over the old machinery at a higher value of
₹ 30 crores. The balance was paid in cash to the vendor.
(x) Investment costing ₹ 36 cores were sold at a loss of ₹ 4 crores.
(xi) Dividends totaling ₹ 30 crores was also paid.
(xii) Debenture interest amounting ₹ 4 crore was paid.
(xiii) Non-cash expenditure incurred during the current year was 1.2 crores
1. Dividends declared during the current year was 15% on equity share capital (ESC =
2. ₹120 crores).

On 31st March 2022, Balance with Bank and Cash on hand totalled ₹ 4 crores. *(RTP Nov '23)*

**Answer 12**

**Cash flow statement (using direct method) for the year ended 31st March, 2023**

| | (₹ in crores) | (₹ in crores) |
|---|---|---|
| Cash flow from operating activities | | |
| Cash sales | 524 | |
| Cash collected from credit customers | 268 | |
| Less: Cash paid to suppliers for goods & services and to employees (Refer Working Note) | (502) | |
| Cash from operations | 290 | |
| Less: Income tax paid | (52) | |
| Net cash from operating activities | | 238 |
| Cash flow from investing activities | | |
| Net Payment for purchase of Machine (50 – 30) | (20) | |
| Proceeds from sale of investments | 32 | |
| Net cash from investing activities | | 12 |
| Cash flow from financing activities | | |
| Redemption of Preference shares | (64) | |
| Proceeds from issue of Equity shares | 48 | |
| Debenture interest paid | (4) | |
| Dividend Paid | (30) | |
| Net cash used in financing activities | | (50) |
| Net increase in cash and cash equivalents | | 200 |
| Add: Cash and cash equivalents as on 1.04.2022 | | 4 |
| Cash and cash equivalents as on 31.3.2023 | | 204 |

**Working Note:**

**Calculation of cash paid to suppliers of goods and services and to employees**

| | (₹ in crores) |
|---|---|
| Opening Balance in creditors Account | 168 |
| Add: Purchases (440 x .8) | 352 |
| Total | 520 |

| | |
|---|---|
| Less: Closing balance in Creditors Account | 184 |
| Cash paid to suppliers of goods | 336 |
| Add: Cash purchases (440 x .2) | 88 |
| Total cash paid for purchases to suppliers (a) | 424 |
| Add: Cash paid to suppliers of other consumables and services (b) | 38 |
| Add: Payment to employees (c) | 40 |
| Total cash paid to suppliers of goods & services and to employees [(a)+ (b) + (c)] | 502 |

## Multiple Choice Questions (MCQs)

**1. Crown Ltd. wants to prepare its cash flow statement. It sold equipment of book value of ₹ 60,000 at a gain of ₹ 8,000. The amount to be reported in its cash flow statement under operating activities is *(SM)***

(a) Nil
(b) 8,000
(c) 68,000
(d) 60,000

**Ans: (a)**

**2. While preparing cash flows statement, an entity (other than a financial institution) should disclose the dividends received from its investment in shares as *(SM)***

(a) Operating cash inflow
(b) Investing cash inflow
(c) Financing cash inflow
(d) Cash & cash equivalent

**Ans: (b)**

**3. XYZ Co. is a financial enterprise. In its cash flow statement, interest paid and dividends received should be *(SM)***

(a) Classified as operating cash flows
(b) Classified as financing cash flows
(c) Not shown in cash flow statement
(d) Classified as investing cash flows

**Ans: (a)**

**4. In the cash flow statement, 'cash and cash equivalents' do not include *(SM)***

(a) Bank balances
(b) Short-term investments readily convertible into Cash are subject to an insignificant risk of changes in value
(c) Cash balances
(d) Loan from bank

**Ans: (d)**

**5. While preparing a Cash Flow Statement using the Indirect method as required under AS 3, which of the following will not be deducted from/added to the Net Profit to arrive at the "Cash flow from Operating activities"? *(SM)***

(a) Interest income
(b) Gain on sale of a fixed asset
(c) Depreciation
(d) Gain on sale of inventory

**Ans: (d)**

**6. How should the dividend paid by the Company should be disclosed in the Cash Flows Statement: *(MTP 2 Marks Dec'24)***

(a) Cash flows from Operating Activities
(b) Cash flows from Investing Activities
(c) Cash flows from Financing Activities
(d) No disclosure in Cash Flow Statement

**Ans : (c)**

B

# CHAPTER 4.3: AS 17- SEGMENT REPORTING

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Definition and identification of reportable segments<br>• Primary and secondary segment reporting formats<br>• Business and geographical segments<br>• Identifying reportable segments<br>• Disclosures | LDR<br>LDR Questions<br>Q 8 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Identifying Reportable Segments as Primary Segment or Secondary Segment

- If the risks and returns of an enterprise are affected predominently by the differences in the Products and services, its primary segment will be business segment and geographic segment will be secondary.
- If the risks and returns of an enterprise are affected predominently by the fact that it operates in different geographical areas, its primary segment will be geographical segment and business segment will be secondary.

### Criteria for Identifying Reportable Segments

- Revenue Test segment revenue>=10 % of all segment revenues
- Result Test Segment result>=10 % of higher of segments in profit or loss
- Assets Test Segment assets>=10% of total assets of all segments
- Management choice- Management may designate any segment as reportable segment despite its size even if tests are not satisfied
- 75% Test- is external revenue of reportable segment <75% of enterprise revenue

### Segment Revenue/ Expenses

| Is aggregate of | Does not include |
|---|---|
| • Portion of enterprise revenue/expense that is directly attributable to a segment, | • Extraordinary items as defined in AS 5 |
| • Relevant portion of enterprise revenue/expense that can be allocated on a reasonable basis to a segment, and | • Interest or dividend income/expense |
| • Revenue from/Expenses relating to transactions with other segments of the enterprise. | • Gains/Loss on sales of investments or on extinguishment of debt.<br>• Income Tax expense, General administrative and head-office expenses, unless directly attributable to a segment's operating activities. |

**Segment Result= Segment Revenue – Segment Expense**

### Segment Assets

| Operating assets | Include | Do not include |
|---|---|---|
| • that are employed by a segment in its operating activities and are either directly attributable or allocated on a reasonable basis to a segment. | • If a segment's result includes interest or dividend income, its assets include related receivables, loans, and investments | • Income tax assets;<br>• assets used for general enterprise or head-office purposes. |

### Segment liabilities

| Operating liabilities | Include | Does not include | |
|---|---|---|---|
| that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis. | If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities. | Income tax liabilities; | borrowings and other liabilities that are incurred for financing rather than operating purposes. |

### Primary Reporting Format

An enterprise should disclose the following for each primary reportable segment:

- **Segment revenue**: External sales and inter-segment transactions
- **Segment result**
- **Total segment assets**
- **Total segment liabilities**
- **Capital expenditure** on long-term tangible and intangible assets
- **Depreciation and amortization** expense for segment assets
- **Significant non-cash expenses** (excluding depreciation and amortization) included in segment expenses

### Secondary Segment Information

If the primary format is a business segment, the enterprise should also report:

- **Segment revenue by geographical area** for regions contributing 10% or more of total revenue
- **Total segment assets by geographical location** for regions with 10% or more of total assets
- **Capital expenditure by geographical location** for regions with 10% or more of total assets

If the primary format is geographical segments, the enterprise should also report for each business segment contributing 10% or more of revenue or assets:

- **Segment revenue from external customers**
- **Total segment assets**
- **Capital expenditure on long-term tangible and intangible assets**

## Question & Answers

### Question 1

**Whether interest expense relating to overdrafts and other operating liabilities identified to a particular segment should be included in the segment expense or not? *(RTP Sep'24)***

**Answer 1**

The interest expense relating to overdrafts and other operating liabilities identified to a particular segment should not be included as a part of the segment expense unless the operations of the segment are primarily of a financial nature or unless the interest is included as a part of the cost of inventories.

### Question 2

**A Company has an inter-segment transfer pricing policy of charging at cost less 5%. The market prices are generally 20% above cost. You are required to examine whether the policy adopted by the company is correct or not? *(MTP 5 Marks Nov '21 & April '23, RTP Jan'25) (RTP May'21, Nov'20, May'22, Nov '19, May'18, Nov'22, SM)***

**Answer 2**

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.

## Question 3

**a) Company A is engaged in the manufacture of chemicals. The company manufactures five types of chemicals that have different applications. Can this company include more than one type of chemical in a single business segment? Comment.**

**b) Is an enterprise required to disclose changes in the basis of allocation of revenue and expenses to segments? Explain.** ***(RTP Nov '21)***

**Answer 3**

a) As per AS 17, "A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products of services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining whether products or services are related include:

(a) the nature of the products of services;

(b) the nature of the productions processes;

(c) the type of class of customers for the products or services;

(d) the methods used to distribute the products or provide the services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities."

As per provisions of the standard, a single business segment does not include products and services with significantly differing risks and returns. Products and services included in a single business segment may be dissimilar with respect to one or several factors listed above but are expected to be similar with respect to majority of the factors. In the present case, the Company should consider whether the chemicals with different applications, have similar risks end returns. For this purpose, the Company should ascertain whether one or more types of chemicals are related keeping in view the relevant factors including those given in the definition of business segment. Chemicals having different applications can be included in a single business segment if majority of the relevant factors including those listed above are similar. This would ensure that the chemicals having significantly different risks and returns are not included in a single business segment.

b) As per AS 17, "Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable." It also states that "some changes in accounting policies relate specifically to segment reporting. Examples include changes in identification of segments and changes in the basis for allocating revenues and expenses to segments. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand and impact of such changes, this Statement requires the disclosure of the nature of change and the financial effect of the change, if reasonably determinable".

In view of the above, a change in the basis of allocation of revenue and expenses to segments is a change in the accounting policy adopted for segment reporting. Accordingly, if the change has a material financial effect on the segment information, a description of the nature of the change, and the financial effect of the change, if it is reasonably determinable, should be disclosed.

## Question 4

**Company A is engaged in the manufacture and sale of products, which constitute two distinct business segments. The products of the Company are sold in the domestic market only. The management information system of the Company is organized to reflect operating information by two broad market segments, rural and urban. Besides the two business segments, how should Company A identify geographical segments? Do geographical segments exist within the same country? Explain in line with the provisions of AS 17. (RTP May 22) (SM)**

**Answer 4**

AS 17 explains that, "a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country". Accordingly, to identity geographical segments, Company A needs to evaluate whether the segments reflected in the management information system function in environments that are subject to significantly differing risks and returns irrespective of the fact whether they are within the same country.

The Standard recognizes that, "Determining the composition of a business or geographical segment involves a certain amount of judgement...". Accordingly, while the management information system of the Company provides segment information for rural and urban geographical segments for the purpose of internal reporting, judgement is required to determine whether these segments are subject to significantly differing risks and returns based on the definition of geographical segment. In making such a judgement, aspect like different pricing and other policies, e.g., credit policies, deployment of resources between different regions etc., may be considered for the purpose identifying 'urban and 'rural' as separate geographical segment. Company A, in making judgment for identifying geographical segments, should also consider the relevance, reliability and comparability over time of segment information that will be reported. The Standard, explains that, "In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in the standard and the qualitative characteristics of financial statements. The qualitative characteristics include the relevance, reliability and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise."

## Question 5

**The accountant of Parag Limited has furnished you with the following data related to its Business Divisions: (₹ in Lacs)**

| Division | A | B | C | D | Total |
|---|---|---|---|---|---|
| Segment Revenue | 100 | 300 | 200 | 400 | 1,000 |
| Segment Result | 45 | -70 | 80 | -10 | 45 |
| Segment Assets | 39 | 51 | 48 | 12 | 150 |

**You are requested to identify the reportable segments in accordance with the criteria laid down in AS 17.** ***(PYP 5 Marks, Nov 20) (Similar to PYP Jan 21 & Nov 19 but different figures, SM) (MTP 5 Marks Sep '23) (RTP Nov '23)***



**Answer 5**

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

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

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

- The combined result of all segments in profit; or

The combined result of all segments in loss, whichever is greater in absolute amount; or Its segment assets are 10% or more of the total assets of all segments.

On the basis of revenue criteria, segments A, B, C and D - all are reportable segments.

On the basis of the result criteria, segments A, B and C are reportable segments (since their results in absolute amount is 10% or more of 125 Lakhs). On the basis of asset criteria, all segments except Dare reportable segments. Since all the segments are covered in at least one of the above criteria, all segments have to be reported

**Exam Insights:** This question was on AS 17 "segment reporting" and examinees were to identify the segments required to be reported and to discuss whether the view of the accountant considering only two segments as reportable, is justified. Many of the examinees did conclude correctly that all the segments are reportable and did not give the justification by identifying, which segment is reportable, according to which criteria of the standard.

## Question 6

**Answer any four of the following:**

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

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

*(PYP 5 Marks May'22, SM)*

**Answer 6**

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

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

- The combined result of all segments in profit; i.e., ₹ 250 Lakhs or
- The combined result of all segments in loss; i.e., ₹ 300 Lakhs Whichever is greater in absolute amount i.e., ₹ 300 Lakhs.

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

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

## Question 7

**Garnet Limited has 4 operating segments. The total revenue (internal and external) and assets are set out as below:**

| Segment | Inter Segment Sales | External Sales | Total Assets |
|---|---|---|---|
| Fan | 3,200 | 10,900 | 23,700 |
| Light | 200 | 1,400 | 13,200 |
| Lamp | 0 | 1,500 | 4,200 |
| Printer | 1,100 | 200 | 3,400 |
| TOTAL | 4,500 | 14,000 | 44,500 |

**How many reportable segments does Garnet Limited have as per the Revenue and Assets criteria given in AS 17? State Reasons for your answer.** *(PYP 5 Marks Nov'23)*

**Answer 7**

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if: Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or Its segment assets are 10% or more of the total assets of all segments. If the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until at least 75% of total enterprise revenue is included in reportable segments. This is not applicable in the given case. In the given case 75% of External Revenue is ₹ 10,500 Lakhs (₹ 14,000 × 75%) and the total External Revenue from Reportable segments is ₹ 12,300 Lakhs. So, no need to add Reportable segments. On the basis of turnover criteria segment Fan is reportable segment as its sales are more than 1,850 lakhs (10% of ₹ 18,500 lakhs). Moreover, total external revenue attributable to reportable segment is also more than 75% of the total enterprise revenue. On the basis of asset criteria, Fan and Light are reportable segments as their assets are more than 4,450 lakhs (10% of ₹ 44,500 lakhs).

Question 8 LDR

**The Chief Accountant of Cotton Garments Limited gives the following data regarding its five segments: (₹ in Crore)**

| Particulars | A | B | C | D | E | Total |
|---|---|---|---|---|---|---|
| Segment Assets | 40 | 15 | 10 | 10 | 5 | 80 |
| Segment Results | (95) | 5 | 5 | (5) | 15 | (75) |
| Segment Revenue | 310 | 40 | 30 | 40 | 30 | 450 |

**The Chief Accountant is of the opinion that segment "A" alone should be reported. Is he justified in his view? Examine his opinion in the light of provisions of AS 17 'Segment Reporting'.**

***(MTP 5 Marks March '23) (RTP May '20 & May '23) (PYP 5 Marks, Jan 21) (Similar to RTP Nov 20 & Nov 19 but different figures) (PYP 5 Marks May '23)***

**Answer 8**

As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

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

(ii) Its segment **result** whether profit or loss is 10% or more of:

(1) The combined result of all segments in profit; or

(2) The combined result of all segments in loss, whichever is greater in absolute amount;

or

(iii) Its segment **assets** are 10% or more of the total assets of all segments.

Further, if the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until at least 75% of total enterprise revenue is included in reportable segments.

Accordingly,

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

(b) On the basis of the **result** criteria, segments A & E are reportable segments (since their results in absolute amount is 10% or more of ₹ 100 crore).

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

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

## Multiple Choice Questions (MCQ)s

**1. As per AS 17, reportable segments are those whose total revenue from external sales and inter-segment sales is *(SM)***

(a) 10% or more of the total revenue of all segments

(b) 10% or more of the total revenue of all external segments

(c) 12% or more of the total revenue of all segments

(d) 12% or more of the total revenue of all external segments

**Ans: (a)**

**2. Which of the following statements is correct? *(SM)***

(a) Management has a discretion to include a segment as a reportable segment even if it passes the 10% materiality test.

(b) Management has a discretion to include any segment as a reportable segment if it fails the 12% materiality test.

(c) It is mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.

(d) It is not mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.

**Ansr: (c)**

**3. Which of the following statements is correct? *(SM)***

(a) The overall test of 75% considers only external revenue to compute the threshold limit.

(b) The overall test of 75% considers only internal revenue to compute the threshold limit.

(c) The overall test of 75% considers both internal and external revenue to compute the threshold limit.

(d) It is management choice whether they want to include both external and internal revenue for computing threshold limit.

**Ans: (a)**

**4. Which of the following statements is correct? *(SM)***

(a) The 10% test computed on the basis of revenue, considers both internal and external revenue to compute the threshold limit.

(b) The 10% test computed on the basis of revenue, considers only external revenue to compute the threshold limit.

(c) The 10% test computed on the basis of revenue, considers only internal revenue to compute the threshold limit.

(d) It is management choice whether they want to include both external and internal revenue for computing threshold limit.

**Ans: (a)**

**5. Which of the following statements is correct? *(SM)***

(a) In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or netloss respectively of all segments taken together becomes reportable segment.

(b) In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit (after netting the losses) of all segments taken together becomes reportable segment.

(c) In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or loss (whichever is higher in absolute figures) of all segments taken together becomes reportable segment.

(d) In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or loss (whichever is lower in absolute figures) of all segments taken together becomes reportable segment.

**Ans: (c)**

C

# CHAPTER 4.4: AS 18- RELATED PARTY DISCLOSURES

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Need for related party relationship disclosure<br>• Identifying related party relationships<br>• Parties not treated as related parties<br>• Exemption from related party disclosure<br>• Disclosure requirements under AS-18 | LDR<br>**LDR Questions**<br>**Q 3** |

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Related Party Relationships**

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

**Control includes**

- Ownership, directly or indirectly, of more than one half of the voting power of an enterprise
- Control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise
- Substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

**Substantial Interest-** An enterprise/individual is considered to have a substantial interest in another enterprise That enterprise or individual owns, directly or indirectly, 20% or more interest in the voting power of the other enterprise

**Associate-** Associate is an enterprise in which an investing reporting party Has significant influence And which is neither a subsidiary nor a joint venture of that party

**Significant Influence-** Significant influence is participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies

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

**In relation to an individual, Relative means**

Spouse, son, daughter, brother, sister, father and mother. Any person who may be expected to influence or be influenced by, that individual and which is neither a subsidiary in his/her dealings with the reporting enterprise.

**Holding Company-** A company having one or more subsidiaries is a holding company

**Subsidiary Company-** In which another company (the holding company) holds, either by itself and/ or through one or more subsidiaries, more than one-half, in nominal value of its equity share capital; or
of which another company (the holding company) controls, either by itself and/ or through one or more subsidiaries, the composition of its board of directors

**Disclosure by Reporting Enterprise:**

- Name of the transacting related party
- Description of the relationship between the parties
- Nature of the transactions
- Volume of transactions (amount or proportion)
- Any other relevant elements for understanding the financial statements
- Outstanding amounts and provisions for doubtful debts from related parties at the balance sheet date
- Amounts written off or written back for debts due from or to related parties

**Question & Answers**

Question 1

**Will transactions with related parties, for services provided/received free of cost, be required to be disclosed? A Limited has a corporate communications department, which centralises the public relations function for the whole group of A Limited and its subsidiaries. No charges are, however, levied by A Limited on its subsidiaries and accordingly, these transactions are not given accounting recognition. Would these constitute related party transactions requiring disclosure under AS 18 in the standalone financial statements of A Limited? *(RTP Jan'25)***

**Answer 1**

These transactions would require disclosure under AS 18 in the standalone financial statements of A Limited. As per paragraph 10 of AS 18, a related party transaction is "a transfer of resources or obligations between related parties, regardless of whether or not a price is charged". In the given situation, there is a transfer of resources from A Limited to its subsidiaries, though no price is charged for the same. Hence, it will constitute as related party transaction and will require disclosure in the financial statements of A Ltd.

Question 2

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

**ii. Shri Manoj a relative of key management personnel received remuneration of ₹ 3,50,000 for his services in the company for the period from 1st April, 2022 to 30th June, 2022. On 1st July, 2022, he left the service.**

**You are required to suggest how the above transactions will be treated as at the closing date i.e. on 31st March, 2023 for the purposes of AS 18- Related Party Disclosures. *(RTP May'24)***

**Answer 2**

i. Mr. Bhola will not be considered as a related party of A Ltd. in view of provisions of AS 18 "Related Party Disclosures" which states, "individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual are related parties".
In the given case, in the absence of share ownership, Mr. Bhola would not be considered to exercise significant influence on A Limited, even though there is an agreement giving him the power to manage the company. Further, the fact that Mr Bhola does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel.

ii. According to AS 18 on 'Related Party Disclosures', parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.
Hence, Shri Manoj, a relative of key management personnel should be identified as related party for disclosure in the financial statements for the year ended 31.3.2023 as he received remuneration for his services in the company for the period from 1st April,2022 to 30th June,2022.

Question 3 LDR

**(i) Mr.Raj a relative of key management personnel received remuneration of Rs. 2,50,000 for his services in the company for the period from 1.4.2020 to 30.6.2020. On 1.7.2020, he left the service. Should the relative be identified as at the closing date i.e. on 31.3.2021 for the purposes of AS 18? (MTP 5 Marks**

March 21, Oct'20, Mar'22, Old & New SM) (Same concept different figures PYP 2.5 Marks July'21, PYP 2.5 Marks, Nov '18)

(ii) X Ltd. sold goods to its associate Company during the 1st quarter ending 30.6.2020. After that, the related party relationship ceased to exist. However, goods were supplied as were supplied to any other ordinary customer. Decide whether transactions of the entire year need disclosure as related party transaction. *(MTP 5 Marks March 21, Oct'20, Mar'22 & Oct '23, SM)*

**Answer 3**

**(i)** According to AS 18 on 'Related Party Disclosures', parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence, Mr. Raj, a relative of key management personnel should be identified as related party for disclosure in the financial statements for the year ended 31.3.2021.

**(ii)** As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.2020 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist need not be reported.

## Question 4

**You are required to identify the related parties in the following cases as per AS 18:**
**M Ltd. holds 61 % shares of S Ltd.**
**S Ltd. holds 51 % shares of F Ltd.**
**C Ltd. holds 49% shares of F Ltd.**
**(Give your answer - Reporting Entity wise for M Ltd., S Ltd., C Ltd. and F Ltd.)** ***(MTP 5 Marks May 20 & Sep '22) (PYP 2.5 Marks May 18)***

**Answer 4**

**(a)** Reporting entity- M Ltd.
- S Ltd. (subsidiary) is a related party
- F Ltd.(subsidiary) is a related party

**(b)** Reporting entity- S Ltd.
- M Ltd. (holding company) is a related party
- F Ltd. (subsidiary) is a related party

**(c)** Reporting entity- F Ltd.
- M Ltd. (holding company) is a related party
- S Ltd. (holding company) is a related party
- C Ltd. (investor/ investing party) is a related party

**(d)** Reporting entity- C Ltd.
- F Ltd. (associate) is a related party

## Question 5

**(i) On the basis of provisions of AS 18 'Related Party Disclosures': Identify the related parties in the following cases:**
**X Limited holds 60% shares of Y Limited**
**Y Limited holds 55% shares of W Limited**
**Z Limited holds 35% shares of W Limited**

**(ii) Himalaya Limited sold goods for ₹ 40 Lakhs to Aravalli Limited during financial year ended on March 31, 2022. The Managing Director of Himalaya Limited owns 80% shares of Aravalli Limited. The sales were made to Aravalli Limited at normal selling prices followed by Himalaya Limited. The chief accountant of Himalaya Limited contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per AS 18. You are required to comment on this.** ***(MTP 5 Marks March '23, RTP Nov '20) (Same concept different figures RTP May'20, RTP Nov'18, SM)***

### Answer 5

**(i)** X Ltd., Y Ltd. & W Ltd. are related to each other. Z Ltd. & W Ltd. are related to each other by virtue of associate relationship. However, neither X Ltd. or Y Ltd. is related to Z Ltd. and vice versa since neither control nor significant influence exists between them.

**(ii)** Himalaya Ltd. and Aravalli Ltd are related parties since key management personnel of Himalaya Ltd. i.e. its managing director holds 80% in Aravalli Ltd. and hence disclosure of transaction between them is required irrespective of whether the transaction was done at normal selling price. Hence the contention of Chief Accountant of Himalaya Ltd that these sales require no disclosure under related party Transactions, is wrong.

## Question 6

**R Ltd. has 60% voting right in S Ltd. S Ltd. has 15% voting right in T Ltd. R Ltd. directly enjoys voting right of 10% in T Ltd. T Ltd. is a listed company and regularly supplies goods to R Ltd. The management of T Ltd. has not disclosed its relationship with R Ltd. You are required to assess the situation from the view point of AS 18 on Related Party Disclosures. *(RTP May 21)***

### Answer 6

AS 18 'Related Party Disclosures', defines related party as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

**Definition for Control**

Here, control is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and Significant Influence is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

**Nature of Relationship**

R Ltd. has direct economic interest in T Ltd. to the extent of 10%, and through S Ltd. in which it is the majority shareholders, it has further control of 9% in T Ltd. (60% of S Ltd.'s 15%). These two taken together (10% + 9%) make the total control of 19%.

**Conclusion**

In the present case, control of R Ltd. in T Ltd. directly and through S Ltd., is only 19%. Significant influence may also not be exercised as an investing party (R Ltd.) holds, directly or indirectly through intermediaries only 19% of the voting power of the T Ltd. Accordingly, R Ltd. and T Ltd. are not related parties. Hence related party disclosure, as per AS 18, is not required.

## Question 7

**SP hotels Limited enters into an agreement with Mr. A for running its hotel for a fixed return payable to the later every year. The contract involves the day-to-day management of the hotel, while all financial and operating policy decisions are taken by the Board of Directors of the company. Mr. A does not own any voting power in SP Hotels Limited. Would he be considered as a related party of SP Hotels Limited? Also explain the required related party disclosure requirements under AS 18? *(MTP 5 Marks April 21, Sep '23, RTP Nov 22, PYP 5 Marks July'21) (Same concepts but lesser adjustments as RTP Nov'19, May'19)***

### Answer 7

Mr. A will not be considered as a related party of SP Hotels Limited in view of AS 18 which states, "individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual". In the given case, in the absence of share ownership, Mr. A would not be considered to exercise significant influence on SP Hotels Limited, even though there is an agreement giving him the power to manage the company. Further, the fact that Mr. A does not have the ability to direct or instruct the board of directors does not qualify him as a key management personnel.

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

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

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

(i) The name of the transacting related party;
(ii) A description of the relationship between the parties;
(iii) A description of the nature of transactions;
(iv) Volume of the transactions either as an amount or as an appropriate proportion;
(v) Any other elements of the related party transactions necessary for an understanding of the financial statements;
(vi) The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;
(vii) Amounts written off or written back in the period in respect of debts due from or to related parties.

## Question 8

**a) In respect of a key supplier who is dependent on the company for its existence and the company enjoys influence over the prices of this supplier (which may not be formally demonstrable), can the supplier and the company be considered as related parties?**

**b) Define "Key management personnel" in the context of AS 18. *(RTP May '22)***

**Answer 8**

(a) The supplier and the company cannot be considered to be related parties merely because the latter is able to influence the transaction price between the parties. Paragraph 3 of AS 18 states that "enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise" are considered to be related party relationships. However, the conditions which define the existence of control, as follows, are not satisfied in the given example.

- 'ownership, directly or indirectly, of more than one-half of the voting power of an enterprise, or
- Control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or
- a substantial interest in voting power and the power to direct, by statue or agreement, the financial and/or operating policies of the enterprise".

Paragraph 10 of the standard defines significant influence as "participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies". In the given example, although the supplier and the company have entered into a commercial transaction, the terms of which are influenced by the latter because of its better bargaining power in the specific market for such goods, it cannot be concluded that there is participation in the financial and/or operating policy decisions. Therefore, as the conditions specified by the Standard for being classified as a related party are not satisfied in the given example, the company cannot be said to be related to the supplier. This view is supported by paragraph 4 of the Standard which states that "a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence" would not be deemed to be related parties.

(b) In context of AS 18, "Key management personnel" are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. For example, in the case of a company, the managing director(s), whole time director(s), manager and any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

## Question 9

**(a) Omega Bank Limited holds 25 per cent of the voting power of B Limited. Omega Bank Limited also provides finance by way of a loan to B Limited at market rates of interest, on account of which, Omega Bank Limited would have the power to nominate one person to the board of directors of B Limited. Any major transactions proposed to be entered into by B Limited would need the consent of Omega Bank Limited. Would Omega Bank Limited be considered as related party for B Ltd. (reporting enterprise)?**

**(b) A Limited has two Associates, B Limited and C Limited, and owns 25 per cent of the voting power of B Limited and 30 per cent of the voting power of C Limited. Would Be Limited be considered a related party for the purpose of financial statements of C Limited? *(RTP Nov '21)***

## Answer 9

(a) Omega Bank Limited would be a related party of B Limited. As per AS 18 "associates and joint ventures of the reporting enterprise and the investing party of venture in respect of which the reporting enterprise is an associate or a joint venture" are related party relationship. Further, an associate has been defined as "an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of the party". Significant influence has been defined to be "participation in the financial and /or operating policy decisions of an enterprise, but not control of those policies". Further, it is given in the standard that significant influence may be gained by share ownership, agreement or statute. As regards share ownership, there is a presumption that ownership of 20 per cent or more of the voting power enables the enterprise to exercise significant influence, unless it could be clearly demonstrated otherwise. In the given example, Omega Bank Limited exercises significant influence over B Limited by virtue of ownership of 25 per cent of the voting power.

Omega Bank Limited is also a provider of finance for B Limited (as it has provided a loan to B Limited), and as per the standard, a provider of finance is deemed not to be a related party during its normal dealings with the enterprise by virtue only of those dealing. However, in this case, the exemption would not be available to Omega Bank Limited as the exercise of significant influence of Omega Bank Limited over B Limited has been demonstrated on account of ownership of more than 20 per cent of voting power. Accordingly, Omega Bank Limited would be construed to be a related party in the financial statements of B Limited and consequently, the latter would be required to disclose the transactions with Omega Bank Limited in its financial statements.

(b) Both B Limited and C Limited are 'associates' of A Limited. Follow-associates cannot be regarded as a related parties only by virtue of the relationship. AS 18 states that "enterprise that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise" are related parties. Further, it is given that "associates and joint ventures of the reporting enterprise and the investing party or venture in respect of which the reporting enterprise is an associate or a joint venture" are also related parties. As B Limited is not an associate of C Limited, nor is it being controlled, directly or indirectly, by C Limited or is not so controlling C Limited, it is not a related party of C Limited.

## Question 10

**Answer the following with respect to AS-18:**

**(i) WIWITSU Ltd. sold goods of ₹ 2,00,000 to its associate company for the 1stquarter ending 30.06.2022. After that the related party relationship ceased to exist. However, goods were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.**

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

**(iii) Asha Ltd. sells all the manufactured furniture of ₹ 1,00,00,000 to Sasha Ltd, as per agreement. Sasha Ltd. is the only customer to Asha Ltd. In the financial statements, Asha Ltd. wants to present Sasha company as a related party. Comment on the disclosure requirement.** ***(PYP 5 Marks May '23)***

## Answer 10

i) As per AS 18, parties are considered to be related if any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party. Transactions of WIWITSU Ltd. with its associate company for the first quarter ending 30.06.2022 only are required to be disclosed as related party transactions as the company has the ability to exercise significant influence only till 30.6.2022.

The transactions for the period in which related party relationship did not exist need not be reported.

ii) In the given case, Arjun Ltd. cannot be said to control the composition of board of directors of Bheem Ltd. as the directors have been appointed in their individual capacity as professionals and not by virtue of their being directors in Arjun Ltd.

Hence, it cannot be concluded that the companies are related merely because the majority of the directors of one company became the majority of the directors of the second in their individual capacity as professionals.

iii) In the context of AS 18, a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business cannot be construed as Related Party Relationship merely by virtue of the resulting economic dependence. There is an economic dependence between the companies but no one controls or exercise significant influence on the other.

In the given case, Asha Ltd. need not report Sasha Company as its related party in its financial statements.

**EXAM INSIGHTS:** This part of the question is based on AS 18 'Related Party Disclosures' wherein three situations have been given to analyze and decide whether the related party relationship exists or not. Most of the examinees were able to analyze and gave the satisfactory answers.

## Multiple Choice Questions (MCQs)

**1. Are the following statements in relation to related parties true or false, according to AS-18 Related Party Disclosures?**

**A) A party is related to another entity that it is jointly controlled by.**

**B) A party is related to another entity that it controls.** ***(SM)***

| Statement (A) | Statement (B) |
|---|---|
| (a) False | False |
| (b) False | True |
| (c) True | False |
| (d) True | True |

**Ans: (d)**

**2. Which of the following is not a related party as envisaged by AS-18 Related Party Disclosures?** ***(SM)***

(a) A director of the entity

(b) The parent company of the entity

(c) A shareholder of the entity that holds 1% stake in the entity

(d) The spouse of the managing director of the entity

**Ans: (c)**

**3. According to AS-18 Related Party Disclosures, related party transaction is a transfer of resources or obligations between related parties – provided a price is charged for such transfer.** ***(SM)***

(a) True

(b) False

**Ans: (b)**

**4. According to AS-18 Related Party Disclosures, parties are considered to be related, if and only if at the end of the reporting period - one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.** ***(SM)***

(a) True

(b) False

**Ans: (b)**

**5. According to AS-18 Related Party Disclosures, which ONE of the following is not a related party of Skyline Limited?** ***(MTP 2 Marks Mar'24, SM)***

(a) A shareholder of Skyline Limited owning 30% of the ordinary share capital

(b) An entity providing banking facilities to Skyline Limited in the normal course of business

(c) An associate of Skyline Limited

(d) Key management personnel of Skyline Limited

**Ans: (b)**

A

# CHAPTER 4.5: AS 20- EARNINGS PER SHARE

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • Basic Earnings Per Share<br>• Issues with numerator (earnings)<br>• Issues with denominator (weighted avg. shares)<br>• Diluted Earnings Per Share<br>• Issues with numerator (earnings)<br>• Issues with denominator (weighted avg. shares)<br>• Dilutive potential equity shares<br>• Restatement of EPS<br>• Disclosures | LDR<br>**LDR Questions**<br>**Q 8** |

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Basic Earnings Per Share

Basic earnings per share is calculated as

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



- For calculating basic earnings per share, the **net profit or loss for the period attributable to equity shareholders** should be the net profit or loss after deducting preference dividends and any attributable tax thereto for the period.
- All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period.
- In a **rights issue**, the exercise price is often less than the fair value of the shares. A rights issue usually includes a bonus element.

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

### Diluted Earnings per Share

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

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

- The net profit for the period attributable to equity shares is:
  - Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period
  - Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares
- The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity Shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

## Question & Answers

### Question 1

**AB Limited is a company engaged in manufacturing industrial packaging equipment. As per the terms of an agreement entered with its debenture holders, the company is required to appropriate adequate portion of its profits to a specific reserve over the period of maturity of the debentures such that, at the redemption date, the reserve constitutes at least half the value of such debentures. As such appropriations are not available for distribution to the equity shareholders, AB Limited has excluded this from the numerator in the computation of Basic EPS. Is this treatment correct as per provisions of AS 20? *(RTP Nov 21)***

**Answer 1**

The appropriation made to such a mandatory reserve created for the redemption of debentures would be included in the net profit attributable to equity shareholders for the computation of Basic EPS. AS 20 states that "For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period". With an emphasis on the phrase attributable to equity shareholders, it may be construed that such amounts appropriated to mandatory reserves, though not available for distribution as dividend, are still attributable to equity shareholders. Accordingly, these amounts should be included in the computation of Basic EPS. In view of this, the treatment made by the company is not correct.

### Question 2

**In the following list of shares issued, for the purpose of calculation of weighted average number of shares, from which date, weight is to be considered:**

**(i) Equity Shares issued in exchange of cash,**
**(ii) Equity Shares issued as a result of conversion of a debt instrument,**
**(iii) Equity Shares issued in exchange for the settlement of a liability of the enterprise,**
**(iv) Equity Shares issued for rendering of services to the enterprise,**
**(v) Equity Shares issued in lieu of interest and/or principal of another financial instrument,**
**(vi) Equity Shares issued as consideration for the acquisition of an asset other than in cash.**
***(RTP May '21, New SM)***

**Answer 2**

The following dates should be considered for consideration of weights for the purpose of calculation of weighted average number of shares in the given situations:

(i) Date of Cash receivable
(ii) Date of conversion
(iii) Date on which settlement becomes effective
(iv) When the services are rendered
(v) Date when interest ceases to accrue
(vi) Date on which the acquisition is recognized.

### Question 3

**a) Stock options have been granted by AB Limited to its employees and they vest equally over 5 years, i.e., 20 per cent at the end of each year from the date of grant. The options will vest only if the employee is still employed with the company at the end of the year. If the employee leaves the company during the vesting period, the options that have vested can be exercised, while the others would lapse. Currently, AB Limited includes only the vested options for calculating Diluted EPS. Should only completely vested options be included for computation of Diluted EPS? Is this in accordance with the provisions of AS 20? Explain. (SM)**

**b) X Limited, as at March 31, 2021, has income from continuing ordinary operations of Rs. 2,40,000, a loss from discontinuing operations of Rs. 3,60,000 and accordingly a net loss of Rs. 1,20,000. The Company has 1,000 equity shares and 200 potential equity shares outstanding as at March 31, 2021. You are required to**

compute Basic and Diluted EPS? *(RTP May 22)*

**Answer 3**

**a)** The current method of calculating Diluted EPS adopted by AB limited is not in accordance with AS 20. The calculation of Diluted EPS should include all potential equity shares, i.e., all the stock options granted at the balance sheet date, which are dilutive in nature, irrespective of the vesting pattern. The options that have lapsed during the year should be included for the portion of the period the same were outstanding, pursuant to the requirement of the standard.

AS 20 states that "A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares". Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans are examples of potential equity shares. Further, for the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

**b)** As per AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations". As income from continuing ordinary operations, ₹2,40,000 would be considered and not Rs. (1,20,000), for ascertaining whether 200 potential equity shares are dilutive or anti-dilutive. Accordingly, 200 potential equity shares would be dilutive potential equity shares since their inclusion would decrease the net profit per share from continuing ordinary operations from Rs. 240 to Rs. 200. Thus the basic E.P.S would be Rs. (120) and diluted E.P.S. would be Rs. (100).

## Question 4

**Explain the concept of 'weighted average number of equity shares outstanding during the period'. Also compute, based on AS 20, the weighted average number of equity shares in the following case:** ***(MTP 5 Marks April 21, April 22)***

| | | No. of shares |
|---|---|---|
| 1st April, 2020 | Balance of equity shares | 7,20,000 |
| 31st August, 2020 | Equity shares issued for cash | 2,40,000 |
| 1st February, 2021 | Equity shares bought back | 1,20,000 |
| 31st March, 2021 | Balance of equity shares | 8,40,000 |

**Answer 4**

As per AS 20, "Earnings Per Share", the weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or less number of shares outstanding at any time. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

Weighted average number of equity shares:

| | |
|---|---|
| 7,20,000 X 5/12 | = 3,00,000 shares |
| 9,60,000 X 5/12 | = 4,00,000 shares |
| 8,40,000 X 2/12 | = 1,40,000 shares |
| | = 8,40,000 shares |

## Question 5

**WIWITZU Limited has a wholly owned subsidiary BC Limited. The Group prepares consolidated Financial Statements for the year ended 31st March, 2024. WIWITZU Limited (in its separate financial statements) has incurred a loss of ₹ 2 crore during the year, while the consolidated profit for the group during the year is ₹ 40 lakh.**

**WIWITZU Limited has 5,00,000 shares outstanding as at 31st March, 2024. Further, it has granted options to issue equity shares as at that date. In respect of such options, 1,00,000 shares are considered to be the shares**

**issued for no consideration. There are no changes in income or expenses that are expected from the issue of equity shares on exercise of these options.**

**Calculate Basic and Diluted EPS for WIWITZU Limited for separate financial statements and for the Group. *(RTP Jan'25)***

**Answer 5**

Computation of earnings per share

| Particulars | Consolidated financial statements | Standalone financial statements of WIWITZU Limited |
|---|---|---|
| Basic earnings/(loss) per share | ₹ 8 [40,00,000/ 5,00,000] | (₹ 40) [2,00,00,000/ 5,00,000] |
| Diluted earnings/ (loss) per share | ₹ 6.66 [40,00,000/ 6,00,000] | (₹ 40) [2,00,00,000/ 5,00,000] |

As per paragraph 39 of AS 20 "Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

In the above case, if the exercise of options was considered for separate financial statements of WIWITZU Limited, the diluted loss per share would have reduced to ₹ 33.33 [2,00,00,000/6,00,000]. As this is antidilutive, the options would not be treated as potentially dilutive equity shares. Accordingly, in the separate financial statements of WIWITZU Limited, the Diluted EPS would be same as Basic EPS.

## Question 6

**"At the time calculating diluted earnings per share, effect is given to all dilutive potential equity shares that are outstanding during the period". Comment and also calculate the basic and diluted earnings per share for the year 2020-21 from the following information:**

| | | |
|---|---|---|
| (i) | Net profit after tax for the year | ₹ 64,12,500 |
| (ii) | No. of equity shares outstanding | 15,00,000 |
| (iii) | No. of 9% convertible debentures of ₹ 100 issued on 1st July,2020 | 75,000 |
| (iv) | Each debenture is convertible into 8 Equity Shares | |
| (v) | Tax relating to interest expenses | 35% |

**(PYP 5 Marks Dec'21)**

**Answer 6**

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period." As per AS 20 'Earnings per Share', the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding* during the period should be adjusted for the effects of all dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

Basic EPS for the year 2020-21= 64,12,500/15,00,000 = ₹ 4.275 or ₹ 4.28

**Computation of diluted earnings per share for year 2020-21**

$$= \frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity Shares}}$$

Adjusted net profit for the current year will be (64,12,500 + 5,06,250 – 1,77,188) = ₹ 67,41,562

No. of equity shares resulting from conversion of debentures: 6,00,000 Shares (75,000 × 8)

Weighted average no. of equity shares used to compute diluted EPS:

(15,00,000 X12/12+ 6,00,000X9/12) = 19,50,000 Shares

Diluted earnings per share: (67,41,562/19,50,000) = ₹ 3.46

**Working Note:**

Interest expense for 9 months = 75,00,000×9%×9/12 =₹ 5,06,250

Tax expense 35 % on interest is ₹1,77,188 (5,06,250 x 35%)

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

## Question 7

The following information is provided to you:

| | |
|---|---|
| Net profit for the year 2022 | ₹ 72,00,000 |
| Weighted average number of equity shares outstanding during the year 2022: | 30,00,000 shares |
| Average Fair value of one equity share during the year 2022: | ₹25.00 |
| Weighted average number of shares under option during the year 2022: | 6,00,000 shares |
| Exercise price for shares under option during the year 2022: | ₹20.00 |

You are required to compute Basic and Diluted Earnings Per Share as per AS 20. *(PYP 5 Marks Nov'22)*

**Answer 7**

**Computation of Basic earnings per share**

| | Earnings ₹ | Shares | Earnings/Share ₹ |
|---|---|---|---|
| Net profit for the year 2022 | 72,00,000 | | |
| Weighted average no. of shares during year2022 | | 30,00,000 | |
| Basic earnings per share (72,00,000/30,00,000) | | | 2.40 |

**Computation of Diluted earnings per share**

| | Earnings ₹ | Shares | Earnings/Share ₹ |
|---|---|---|---|
| Net profit for the year 2022 | 72,00,000 | | |
| Weighted average no. of shares during year 2022 | | 30,00,000 | |
| Number of shares under option | | 6,00,000 | |
| Number of shares that would have been issued at fair value | | | |
| (6,00,000 x 20.00)/25.00 | | (4,80,000) | |
| **Diluted earnings per share** | **72,00,000** | **31,20,000** | **2.31** |
| | | | **(rounded-off)** |

Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (1,20,000) deemed for the purpose of the computation to have been issued for no consideration.

To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of options.

## Question 8

LDR

From the following information, you are required to compute the basic and adjusted Earnings per share:

| | |
|---|---|
| Net profit for 2015-16 | 11 lakh |
| Net profit for 2016-17 | 15 lakh |
| No. of shares issued before rights issue | 5 lakhs |
| Right issue | One for every 5 held |
| Right issue price | 15 per share |
| Last date of exercising right option | 1-06-2016 |
| Fair value of shares before right issue | 21 per share |

*(MTP 5 Marks- Mar'19, Mar'18) (Same concept different figures MTP 5 Marks May'20, MTP 5 Marks Sep'22, RTP Nov'20, RTP Nov'18, May'23, Nov'23, PYP 5 Marks Nov'19, SM, RTP Sep'24, PYP 5 Marks Nov'23)*

**Answer 8**

**Computation of theoretical ex-rights fair value per Share**

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

$$\frac{(Rs.21.00 \times 5,00,000\ Shares)+(Rs.15.00 \times 1,00,000\ Shares)}{5,00,000\ Shares+1,00,000\ Shares}$$

Theoretical ex-rights fair value per share = Rs. 20.00

**Computation of earnings per share**

**(a) Computation of adjustment factor**

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

| | Year 2015-16 | Year 2016-17 |
|---|---|---|
| EPS for the year 2015-16 as originally reported: (Rs. 11,00,000/5,00,000 shares) | Rs.2.20 | |
| EPS for the year 2015-16 restated for rights issue: [Rs. 11,00,000/ (5,00,000 shares x 1.05)] | Rs.2.10 | |
| EPS for the year 2016-17 including effects of rights issue $\frac{15,00,000}{\left(5,00,000 \times 1.05 \times \frac{2}{12}\right) + \left(6,00,000 \times \frac{10}{12}\right)}$ | | Rs. 2.55 |

## Question 9

**On 1st April 2021 a company had 6,00,000 equity shares of Rs. 10 each (Rs. 5 paid up by all shareholders). On 1st September, 2019 the remaining Rs. 5 was called up and paid by all shareholders except one shareholder having 60,000 equity shares. The net profit for the year ended 31st March, 2022 was Rs. 21,96,000 after considering dividend on preference shares and dividend distribution tax on such dividend totaling to Rs. 3,40,000. You are required to compute Basic EPS for the year ended 31st March, 2022 as per Accounting Standard 20 "Earnings Per Share". *(MTP 5 Marks Mar'22, Oct '20 & Oct '21, March '23 & Oct '23, PYP 5 Marks, May '18, SM)***

**Answer 9**

Basic Earnings per share (EPS) = $\frac{\text{Net Profit attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$

= $\frac{21,96,000}{4,57,500 \text{ Shares (as per working note)}}$ = Rs. 4.80 per share

**Working Note:**

**Calculation of weighted average number of equity shares**

As per AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated as follows:

| Date | No. of equity shares | Amount paid per share | Weighted average no. of equity shares |
|---|---|---|---|
| | Rs. | Rs. | Rs. |
| 1.4.2020 | 6,00,000 | 5 | 6,00,000 x 5/10 x 5/12 = 1,25,000 |
| 1.9.2020 | 5,40,000 | 10 | 5,40,000 x 7/12 = 3,15,000 |
| 1.9.2020 | 60,000 | 5 | 60,000 x 5/10 x 7/12 = 17,500 |
| **Total weighted average equity shares** | | | **4,57,500** |

## Question 10

**NAT, a listed entity, as on 1st April,2021 had the following capital structure:**

| | ₹ |
|---|---|
| **10,00,000 Equity Shares having face value of ₹ 1 each** | **10,00,000** |
| **10,00,000 8% Preference Shares having face value of ₹ 10 each** | **1,00,00,000** |

**During the year 2021-2022, the company had profit after tax of ₹ 90,00,000**

On 1st January,2022, NAT made a bonus issue of one equity share for every 2 equity shares outstanding as at 31st December,2021.

On 1st January,2022, NAT issued 2,00,000 equity shares of ₹ 1 each at their full market price of ₹ 7.60 per share. NAT's shares were trading at ₹ 8.05 per share on 31st March,2022.

Further it has been provided that the basic earnings per share for the year ended 31st March,2021 was previously reported at ₹ 62.30.

You are required to:

(i) Calculate the basic earnings per share to be reported in the financial statements of NAT for the year ended 31st March,2022 including the comparative figure, in accordance with AS-20 Earnings Per Share.

(ii) Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share? *(PYP 5 Marks May'22, SM)*

**Answer 10**

**(i)** Calculation of Basic Earnings per share for the year ended 31stMarch, 2022 including the comparative figure:

(a) Earnings for the year ended 31st March, 2021 = EPS x Number of shares outstanding during 2020-2021
= ₹ 62.30 x 10,00,000 equity shares
= ₹ 6,23,00,000

(b) Adjusted Earnings per share after taking into consideration bonus issue
Adjusted Basic EPS = Earnings for the year 2020-2021 / Total outstanding shares +Bonus issue
= ₹ 6,23,00,000 / (10,00,000+ 5,00,000)
= ₹ 6,23,00,000 / 15,00,000
= ₹ 41.53 per share

(c) Basic EPS for the year 2021-2022
Basic EPS = Total Earnings – Preference Shares Dividend) / (Total shares outstanding at the beginning + Bonus issue + weighted average of the shares issued in January, 2022)
= (₹ 90,00,000 – ₹ (1,00,00,000 x 8%) / (10,00,000 + 5,00,000 + (2,00,000 x 3/12))
= ₹ 82,00,000 / 15,50,000 shares
= ₹ 5.29 per share

**(ii)** In case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2021, the earliest period reported.

However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

## Question 11

From the following information, you are required to compute Basic and Diluted Earnings Per Share (EPS) of M/s. WIWITZU Limited for the year ended 31st March, 2019:

| | |
|---|---|
| Net Profit for the year after tax: | ₹75,00,000 |
| Number of Equity Shares of Rs.10 each outstanding: | ₹10,00,000 |

1,00,000, 8% Convertible Debentures of Rs. 100 each were issued by the Company at the beginning of the year. 1,10,000 Equity Shares were supposed to be issued on conversion. Consider rate of Income Tax as 30% *(MTP 5 Marks Oct'18, RTP May 20) (Same concept different figures- MTP 5 Marks Nov'21, RTP Nov'19, RTP May'19, RTP Nov'22, RTP May'18)*

**Answer 11**

**Computation of basic earnings per share**

Net profit for the current year / Weighted average number of equity shares outstanding during the year
Rs. 75,00,000 / 10,00,000 = Rs. 7.50 per share

**Computation of diluted earnings per share** = $\frac{\text{Adjusted net profit for the current year}}{\text{Weighted average number of equity shares}}$

**Adjusted net profit for the current year**

| | ₹ |
|---|---|
| **Net profit for the current year** | **75,00,000** |
| **Add: Interest expense for the current year** | **8,00,000** |
| **Less: Tax relating to interest expense (30% of ₹8,00,000)** | **(2,40,000)** |
| | |
| **Adjusted net profit for the current year** | **80,60,000** |

**Number of equity shares resulting from conversion of debentures**

= 1,10,000 Equity shares (given in the Question)

**Weighted average number of equity shares used to compute diluted earnings per share**

= 11,10,000 shares (10,00,000 + 1,10,000)

**Diluted earnings per share**

= Rs. 80,60,000/ 11,10,000

= Rs. 7.26 per share

**Note**: Conversion of convertible debentures into Equity Share will be dilutive potential equity shares. Hence, to compute the adjusted profit the interest paid on such debentures will be added back as the same would not be payable in case these are converted into equity shares.

## Question 12

**On 1 April 2023, VIWITSU Limited has given the following information:**

| | ₹ |
|---|---|
| **50,000 equity shares of ₹ 100 each (₹ 80 paid up by allshareholders)** | **40,00,000** |
| **2,00,000 8% Preference shares of ₹ 10 each** | **20,00,000** |
| **10,000, 12% Debentures of ₹ 100 each** | **10,00,000** |
| **(Each debenture is convertible into 3 equity shares of ₹ 100each)** | |

**On 1" July 2023, the remaining ₹ 20 was called up and paid by all the shareholders except one shareholder holding 10,000 equity shares. During the year 2023-24 the company had a profit after tax of ₹ 3,44,000.**

**Tax rate is 30%.**

**You are required to compute Basic and Diluted EPS.** ***(PYP 4 Marks May'24)***

**Answer 12**

Basic Earnings per share (EPS) = $\frac{\text{Net profit attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$

$= \frac{1{,}84{,}000}{46{,}000 \text{ Shares (as per working note)}}$

= ₹4 per share

**Diluted earnings per share**

| | |
|---|---|
| Net profit for the current year | ₹3,44,000 |
| No. of equity shares outstanding | 50,000 |
| Basic earnings per share | ₹4 |
| No. of 12% convertible debentures of ₹100each Each debenture is convertible into 3 equityshares | 10,000 |
| Interest expense for the current year | ₹1,20,000 |
| Tax relating to interest expense (30%) | ₹36,000 |
| Adjusted net profit for the current year | ₹(1,84,000 + 1,20,000 - 36,000) = ₹2,68,000 |
| No. of equity shares resulting from conversion of debentures | 30,000 |
| No. of equity shares used to compute dilutedearnings per share | 46,000 + 30,000 = 76,000 |
| Diluted earnings per share | 2,68,000 / 76,000 = ₹3.53 |

**Working Note:**

1. **Net profit attributable to equity share holders = Net profit lesspreference dividends**

   Total earnings – preference shares dividend

   ₹3,44,000 – ₹(8% x 20,00,000)

   ₹3,44,000 - ₹1,60,000

   = ₹1,84,000

2. **Calculation of weighted average number of equity shares**

   As per AS 20 'Earnings Per Share', partly paid equity shares are treated as a fraction of equity share to the extent that they were entitled to participate in dividend relative to a fully paid equity share during the reporting period. Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weightedaverage number of shares will be calculated as follows:

| Date | No. of equity shares | Amount paid per share | Weighted average no. of equity shares |
|---|---|---|---|
| | ₹ | ₹ | ₹ |
| 01.04.2023 | 50,000 | 80 | 50,000x 80/100x 3/12 = 10,000 |
| 01.07.2023 | 40,000 | 100 | 40,000 x 9/12 = 30,000 |
| 01.07.2023 | 10,000 | 80 | 10,000x 80/100x 9/12 = **6,000** |
| Total weighted average equity shares | | | **46,000** |

## Question 13

**Following information is supplied by K Ltd.:**

**Number of shares outstanding prior to right issue - 2,50,000 shares.**

**Right issue - two new share for each 5 outstanding shares (i.e. 1,00,000 new shares)**

**Right issue price - ₹ 98**

**Last date of exercising rights - 30-06-2023.**

**Fair value of one equity share immediately prior to exercise of right on 30-06-2023 is ₹ 102.**

**Net Profit to equity shareholders: 2022-2023 ₹ 50,00,000**

**2023-2024 - ₹ 75,00,000**

**You are required to calculate the basic earnings per share as per AS-20 Earnings per Share.** ***(MTP 4 Marks Nov'24)***

**Answer 13**

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

$$\frac{102 \times 2{,}50{,}000 \text{ Share} + ₹\ 98 \times 1{,}00{,}000 \text{ Share}}{3{,}50{,}000 \text{ Shares}}$$

Theoretical ex-rights fair value per share = ₹ 100.86

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex} - \text{rights value per share}} = 102 / 100.86 = 1.01$$

**Computation of earnings per share:**

EPS for the year 2022-23 as originally reported: ₹ 50,00,000/2,50,000 shares = ₹ 20

EPS for the year 2022-23 restated for rights issue: = ₹ 50,00,000/ (2,50,000 shares x 1.01)
= ₹ 19.80

EPS for the year 2023-24 including effects of rights issue:

EPS = 75,00,000/3,25,625* = ₹ 23.03

* [(2,50,000 x 1.01 x 3/12) + (3,50,000 x 9/12)] = 63,125 + 2,62,500
= 3,25,625 shares

**Note**: Financial year (ended 31st March) is considered as accounting year while giving the above answer.

## Multiple Choice Questions (MCQs)

**1. AB Company Ltd. had 1,00,000 shares of common stock outstanding on January 1. Additional 50,000 shares were issued on July 1, and 25,000 shares were re- acquired on September 1. The weighted average number of shares outstanding during the year on Dec. 31 is *(SM)***

(a) 1,40,000 shares
(b) 1,25,000 shares
(c) 1,16,667 shares
(d) 1,20,000 shares

**Ans: (c)**

**2. As per AS 20, potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would *(SM)***

(a) Decrease net profit per share from continuing ordinary operations.
(b) Increase net profit per share from continuing ordinary operations.
(c) Make no change in net profit per share from continuing ordinary operations.
(d) Decrease net loss per share from continuing ordinary operations

**Ans: (a)**

**3. As per AS 20, equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements are *(SM)***

(a) Dilutive potential equity shares
(b) Contingently issuable shares
(c) Contractual issued shares
(d) Potential equity shares

**Ans: (b)**

**4. In case potential equity shares have been cancelled during the year, they should be: *(SM)***

(a) Ignored for computation of Diluted EPS.
(b) Considered from the beginning of the year till the date they are cancelled.
(c) The company needs to make an accounting policy and can follow the treatment in (a) or (b) as it decides.
(d) Considered for computation of diluted EPS only if the impact of such potential equity shares would be material.

**Ans: (b)**

**5. Partly paid-up equity shares are: *(SM)***

(a) Always considered as a part of Basic EPS.
(b) Always considered as a part of Diluted EPS.
(c) Depending upon the entitlement of dividend to the shareholder, it will be considered as a part of Basic or Diluted EPS as the case may be.
(d) Considered as part of Basic/ Diluted EPS depending on the accounting policy of the company.

**Ans: (c)**

**6. As per AS 20 an enterprise should present/disclose the following:**

**(i) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period.**
**(ii) the weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other.**
**(iii) basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).**
**(iv) the nominal value of shares along with the earnings per share figures. *(MTP 2 Marks Nov'24)***

(a) All the statements are correct
(b) Statements (a), (b) and (c) are correct
(c) Statements (b), (c) and (d) are correct
(d) Statements (a), (b) and (c) are correct

**Ans: (a)**

C

# CHAPTER 4.6: AS-24 DISCONTINUING OPERATIONS

| CONCEPTS OF THIS CHAPTER | |
|---|---|
| • **Discontinuing Operation:** Part of entity being disposed of or abandoned, affecting financials.<br>• **Initial Disclosure Event:** Event marking start of discontinuation, triggering disclosure.<br>• **Recognition & Measurement Principles:** Guidelines for identifying and valuing assets, liabilities in discontinuation.<br>• **Presentation & Disclosures:** Required reporting of discontinuing operations in financial statements | LDR<br>**LDR Questions**<br>**Q 6** |

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Discontinuing Operation

A discontinuing operation is a component of an enterprise

- Pursuant to a single plan, disposing substantially entirely via sale, demerger, or spin-off, piecemeal sale of assets and liability settlement, or termination by abandonment.
- That represents a separate major line of business or geographical area of operations
- That can be distinguished operationally and for financial reporting purposes.



### Initial Disclosure Event

| | |
|---|---|
| **The initial disclosure event is the occurrence of one of the events, whichever occurs earlier:** | Enterprise has entered into a binding sale agreement for substantially all of the assets attributable to discontinuing operation or |
| | Enterprise's board of directors or similar governing body has approved a detailed, formal plan for the discontinuation and made an announcement of the plan. |

### Presentation and Disclosure

**Should be presented in the notes of Financial Statements:**

| | |
|---|---|
| • A description of the discontinuing operation(s). | • The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period |
| • The business or geographical segment(s) in which it is reported. | • The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto. |
| • The date and nature of the initial disclosure event. | • The amounts of revenue and expenses in respect of the ordinary activitie attributable to the discontinuing operation during the current financial reporting period. |
| • The date or period in which the discontinuance is expected to be completed if known or determinable. | • The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled. |

**Should be presented on the face of the Statement of Profit & Loss:**

| | |
|---|---|
| The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto | The amount of the pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to the discontinuing operation. |

## Question & Answers

### Question 1

**What is the disclosure requirement in interim financial reports as per AS 24 for discontinuing operations? *(RTP Nov'22)***

**Answer 1**

Disclosure in interim financial reports

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

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

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

### Question 2

**What are discontinuing operations as per AS 24? Should an enterprise include prescribed information relating to a discontinuing operation in its financial statements? *(RTP Nov '21)***

**Answer 2**

A discontinuing operation is a component of an enterprise:

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

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

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

  (iii) Terminating through abandonment and

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

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

An enterprise should include prescribed information relating to a discontinuing operation in its financial statements, as per requirements of AS 24, beginning with the financial statements for the period in which the initial disclosure event occurs.



### Question 3

**A consumer goods producer has changed the product line as follows:**

| | Dish washing Bar (Per month) | Clothes washing Bar (Per month) |
|---|---|---|
| January 2021 - September 2021 | 2,00,000 | 2,00,000 |
| October 2021 - December 2021 | 1,00,000 | 3,00,000 |
| January 2022 - March 2022 | Nil | 4,00,000 |

**The company has enforced a gradual enforcement of change in product line on the basis of an overall plan. The Board of Directors has passed a resolution in March 2021 to this effect. The company follows calendar year as its accounting year.**

**You required to advise the company whether it should be treated as discontinuing operation or not as per AS 24? *(RTP May '23, MTP 5 Marks Apr'19, Aug'18, RTP May'18, SM)***

**Answer 3**

As per AS 24 'Discontinuing Operations', a discontinuing operation is a component of an enterprise:

(i) that the enterprise, pursuant to a single plan, is:

  (1) disposing of substantially in its entirety,

  (2) disposing of piecemeal, or

  (3) terminating through abandonment; and

(ii) that represents a separate major line of business or geographical area of operations; and

(iii) that can be distinguished operationally and for financial reporting purposes.

As per provisions of the standard, business enterprises frequently close facilities, abandon products or even product lines, and change the size of their work force in response to market forces. While those kinds of terminations generally are not, in themselves, discontinuing operations, they can occur in connection with a discontinuing operation. Examples of activities that do not necessarily satisfy criterion of discontinuing operation are gradual or evolutionary phasing out of a product line or class of service, discontinuing, even if relatively abruptly, several products within an ongoing line of business;

In the given case, the company has enforced a gradual enforcement of change in product line and does not represent a separate major line of business and hence is not a discontinued operation. If it were a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

(iv) the enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or

(v) the enterprises board of directors or similar governing body has both approved a detailed, formal plan for discontinuance and made an announcement of the plan.

## Question 4

**Vivi Tsu Ltd. is in the business of manufacture of Passenger cars and commercial vehicles. The company is working on a strategic plan to shift from the Passenger car segment over the coming 5 years. However, no specific plans have been drawn up for sale of neither the division nor its assets. As part of its plan it will reduce the production of passenger cars by 20% annually. It also plans to commence another new factory for the manufacture of commercial vehicles plus transfer of employees in a phased manner.**

**(i) You are required to comment if mere gradual phasing out in itself can be considered as a 'Discontinuing Operation' within the meaning of AS 24.**

**(ii) If the company passes a resolution to sell some of the assets in the passenger car division and also to transfer few other assets of the passenger car division to the new factory, does this trigger the application of AS 24?**

**(iii) Would your answer to the above be different if the company resolves to sell the assets of the Passenger Car Division in a phased but time bound manner? *(RTP Sep'24, RTP May'24,New SM)***

**Answer 4**

Mere gradual phasing out is not considered as discontinuing operation as defined under para 3 of AS 24, 'Discontinuing Operations'.

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

(1) Gradual or evolutionary phasing out of a product line or class of service;

(2) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

(3) Shifting of some production or marketing activities for a particular line of business from one location to another; and

(4) Closing of a facility to achieve productivity improvements or other cost savings.

**In view of the above the answers are:**

(i) No, the companies' strategic plan has no final approval from the board through a resolution and there is no specific time bound activities like shifting of assets and employees. Above all, the new segment i.e. commercial vehicle production line in a new factory has not started.

(ii) No, the resolution is salient about stoppage of the Car segment in definite time period. Though, sale of some assets and some transfer proposal were passed through a resolution to the new factory, closure road map and new segment starting roadmap are missing. Hence, AS 24 will not be applicable.

(iii) Yes, phased and time bound programme resolved in the board clearly indicates the closure of the passenger car segment in a definite time frame and will constitute a clear roadmap. Hence, this action will attract compliance of AS 24.

## Question 5

**Rohini Limited is in the business of manufacture of passenger cars and commercial vehicles. The Company is working on a strategic plan to close the production of passenger cars and to produce only commercial vehicles over the coming 5 years. However, no specific plans have been drawn up for sale of neither the division nor its assets. As part of its prospective plan it will reduce the production of passenger cars by 20% annually. It also plans to establish another new factory for the manufacture of commercial vehicles and transfer surplus employees in a phased manner. You are required to comment:**

**(i) If mere gradual phasing out in itself can be considered as a 'discontinuing operation' within the meaning of AS-24.**

(ii) **If the Company passes a resolution to sell some of the assets in the passenger car division and also to transfer few other assets of the passenger car division to the new factory, does this trigger the application of AS-24?**

(iii) **Would your answer to the above be different if the Company resolves to sell the assets of the passenger car division in a phased but time bound manner? *(PYP 5 Marks July 21,New SM) (Same concept lesser adjustments RTP May'21)***

**Answer 5**

**(i) As per AS 24, a discontinuing operation is a component of an enterprise:**

(a) that the enterprise, pursuant to a single plan, is:
   (i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or
   (ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or
   (iii) terminating through abandonment; and

(b) that represents a separate major line of business or geographical area of operations; and

(c) that can be distinguished operationally and for financial reporting purposes.

Mere gradual phasing out is not considered as discontinuing operation as defined under AS 24, 'Discontinuing Operations'. Examples of activities that do not necessarily satisfy criterion of the definition, but that might do so in combination with other circumstances, include:

(a) Gradual or evolutionary phasing out of a product line or class of service;

(b) Shifting of some production or marketing activities for a particular line of business from one location to another; and

(c) Closing of a facility to achieve productivity improvements or other cost savings. In this case, it cannot be considered as Discontinuing Operation as per AS-24 as the and there is no specific time bound activities like shifting of assets and employees. Moreover, the new segment i.e., commercial vehicle production line in a new factory has not started.

**(ii)** No, the resolution is salient about stoppage of the Car segment in definite time period. Though, sale of some assets and some transfer proposals were passed through a resolution to the new factory, but the closure road map and new segment starting roadmap are missing.

Hence, AS 24 will not be applicable and it cannot be considered as Discontinuing operations.

**(iii)** Yes, phased and time bound program resolved in the board clearly indicates the closure of the passenger car segment in a definite time frame and will constitute a clear roadmap.

Hence, this action will attract compliance of AS 24 and it will be considered as Discontinuing Operations as per AS-24.

## Question 6 — LDR

**What are the disclosure and presentation requirements of AS 24 for discontinuing operations?**
**Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances. *(RTP Jan'25, PYP 5 Marks Nov'23, RTP May 20, Nov 18, May 22, SM)***

**Answer 6**

**(i)** An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:

(a) a description of the discontinuing operation(s);

(b) (b) the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;

(c) the date and nature of the initial disclosure event;

(d) the date or period in which the discontinuance is expected to be completed if known or determinable;

(e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;

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

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

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

**(ii)** Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operations. According to Paragraph 9 of AS 24, examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

(i) Gradual or evolutionary phasing out of a product line or class of service;

(ii) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

(iii) Shifting of some production or marketing activities for a particular line of business from one location to another; and

(iv) Closing of a facility to achieve productivity improvements or other cost savings.

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

**Multiple Choice Questions (MCQs)**

**1. AB decided to dispose of its Clothing division as part of its long-term strategy.**

**(a) Date of Board approval - 1st March 20X1;**

**(b) Date of formal announcement made to affected parties - 15th March 20X1.**

**(c) Date of Binding Sale agreement – 1st July 20X1;**

**(d) Reporting date – 31st March 20X1**

**The date of initial disclosure event would be: *(SM)***

(a) 1st March 20X1

(b) 15th March 20X1

(c) 31st March 20X1

(d) 31st July 20X1

**Ans: (b)**

**2. To qualify as a component that can be distinguished operationally and for financial reporting purposes, the condition(s) to be met is (are): *(SM)***

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

(b) Its revenue can be directly attributed to it.

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

(d) All of the above

**Ans: (d)**

**3. Identify which of the following statements is incorrect? *(SM)***

(a) A discontinuing operation is a component of an enterprise that representsa separate major line of business or geographical area of operations.

(b) A discontinuing operation is a component of an enterprise that can be distinguished operationally and for financial reporting purposes.

(c) A discontinuing operation is a component of an enterprise that may ormay not be distinguished operationally and for financial reporting purposes.

(d) A discontinuing operation may be disposed of in its entirety or piecemeal, but always pursuant to an overall plan to discontinue the entire component.

**Ans: (c)**

**4. Identify the incorrect statement. *(SM)***

(a) Discontinuing operations are infrequent events, but this does not meanthat all infrequent events are discontinuing operations.

(b) The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 would always raise a question regarding the enterprise's ability to continue as a going concern.

(c) For recognising and measuring the effect of discontinuing operations, AS 24 does not provide any guidelines, but for the purpose the relevantAccounting Standards should be referred.

(d) An enterprise shall include a description of the discontinuing operation,in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs.

**Answer: (b)**

# CHAPTER 4.7: AS-25 INTERIM FINANCIAL REPORTING

**CONCEPTS OF THIS CHAPTER**

- Objective & scope of AS 25
- Content & Minimum components of Interim Financial Report
- Form & content of Interim Financial Statements
- Selected Explanatory Notes
- Periods for Interim Financial Statements
- Disclosure in Annual Financial Statements
- Recognition & Measurement principles under the Standard

**LDR Questions**
**Q 7**

## QUICK REVIEW OF IMPORTANT CONCEPTS

- **Interim period** is a financial reporting period shorter than a full financial year, it focuses on new activities, events, and circumstances and does not duplicate information previously reported.
- **Interim financial report** means a financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.
- During the first year of operations of an enterprise, its annual financial reporting period may be shorter than a financial year. In such a case, that shorter period is not considered as an interim period



### Form and Content of Interim Financial Statements

- A complete interim financial report should follow the same form and content as annual financial statements.
- Condensed interim financial statements must include key headings, sub-headings, and required explanatory notes.

### Selected Explanatory Notes

An enterprise should include the following information, if material and if not disclosed elsewhere:

(a) Confirmation of consistent accounting policies or details of changes.
(b) Seasonal effects on interim operations.
(c) Unusual items affecting financials per AS 5.
(d) Material changes in estimates from prior periods.
(e) Debt, equity, and share restructuring activities.
(f) Dividend details for equity and other shares.
(g) Segment revenue, capital employed, and results per AS 17.
(h) Changes in enterprise composition (e.g., mergers, acquisitions, disposals).
(i) Material changes in contingent liabilities.

### Periods for which Interim Financial Statements are Required to be Presented

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

### Materiality

- Interim measurements rely more on estimates than annual data.
- Materiality is assessed based on interim period financial data for clarity

**Revenue Received Seasonally or Occasionally**= Should be recognized when they occur
**Cost Incurred unevenly during the FY =** should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the FY.

## Question & Answers

### Question 1

**On 30-6-2017, L Limited incurred Rs. 6,00,000 net losses from disposal of a business segment. Also, on 31-7-2017, the company paid Rs. 1,60,000 for property taxes assessed for the calendar year 2017. How should the above transactions be included in determination of net income of L Limited for the six months interim period ended on 30-9-2017? *(MTP 4 Marks Aug 17)***

**Answer 1**

Para 28 of AS 25 "Interim Financial Reporting" states that revenues and gains should be recognized in interim reports on the same basis as used in annual reports. As at September 30, 2017, L Ltd. would report the entire Rs. 6,00,000 losses on the disposal of its business segment since the loss was incurred during the interim period. A cost charged as an expense in an annual period should be allocated among the interim periods, which are clearly benefited from the expense, through the use of accruals and/or deferrals. Since Rs. 1,60,000 property tax payment relates to the entire 2017 calendar year, only Rs. 80,000 of the payment would be reported as an expense at September 30, 2017, while out of the remaining Rs. 80,000, Rs. 40,000 for Jan. 2017 to March, 2017 would be shown as payment of the outstanding amount of previous year and another Rs. 40,000 related to quarter October, 2017 to December, 2017, would be reported as a prepaid expense.

### Question 2

**A Ltd. is dealing in seasonal products. The following is the quarterly sales pattern of the product:**

| Quarter 1 | II | III | IV |
|---|---|---|---|
| Ending 31st March | 30th June | 30th September | 31st December |
| 20% | 20% | 50% | 25% |

**For the first quarter ending 31st March, 2020, A Ltd. gives you the following information:**

| | Rs. in crore |
|---|---|
| Sales | 100 |
| Salary and other expenses | 60 |
| Advertisement expenses (routine) | 4 |
| Administrative and selling expenses | 8 |

**While preparing interim financial report for the first quarter, A Ltd. wants to defer Rs. 42 crore expenditure to third quarter on the argument that third quarter is having more sales, therefore third quarter should be debited by higher expenditure, considering the seasonal nature of business. The expenditures are uniform throughout all quarters. Calculate the result of first quarter as per AS 25 and comment on the A Ltd. view. *(RTP Nov 20)***

**Answer 2**

**Calculation of the result of first quarter as per AS 25**

| **Particulars** | | **(Rs.in crore)** |
|---|---|---|
| Result of first quarter ending 31st March, 2020 | | |
| Turnover | | 100 |
| Other Income | | Nil |
| Total (a) | | 100 |
| Less: | Changes in inventories | Nil |
| | Salaries and other expenses | 60 |
| | Administrative and selling expenses (4 + 8) | **12** |
| Total (b) | | 72 |

| | |
|---|---|
| Profit (a)-(b) | 28 |

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

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

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

The expenditure of Rs. 42 crores made in the first quarter shall be charge in that quarter only i.e., when they are earned and incurred. Therefore, the argument given by A Ltd. relating to deferment of Rs. 42 crore is not tenable as expenditures are uniform throughout all quarters.

## Question 3

**Faithful Ltd. is dealing in seasonal product sales pattern of the product, quarter wise is as follows:**

| | |
|---|---|
| **1st quarter 30th June** | **10%** |
| **2nd quarter 30th September** | **10%** |
| **3rd quarter 31st December** | **60%** |
| **4th quarter 31st March** | **20%** |

**Information regarding the 1st quarter ending on 30th June, 2018 is as follows:**

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

**While preparing interim financial report for first quarter Faithful Ltd. wants to defer Rs. 10 crore expenditure to third quarter on the argument that third quarter is having more sales therefore third quarter should be debited by more expenditure. Considering the seasonal nature of business and the expenditures are uniform throughout all quarters, calculate the result of the first quarter as per AS 25. Also give a comment on the company's view. *(RTP May 19)***

**Answer 3**

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

**Correct Statement of Profit or Loss for the quarter ending on 30 th June, 2018 would be**

| **Particulars** | **(Rs.in crore)** | |
|---|---|---|
| Result of first quarter ending 30th June, 2018 | | |
| Turnover | 80 | |
| Other Income | Nil | |
| Total (a) | | 80 |
| Less: Changes in inventories | | Nil |
| Salaries and other cost | | 60 |
| Administrative and selling Expenses (4+8) | | 12 |
| Total (b) | | 72 |
| Profit (a)-(b) | | 8 |

## Question 4

**To comply with listing requirements and other statutory obligations, Wivit Su Ltd. prepares interim financial reports at the end of each quarter. The company has brought forward losses of Rs. 350 lakhs under Income-tax Law, of which 90% is eligible for set off as per the recent verdict of the Court, that has attained finality. No deferred tax asset has been recognized on such losses in view of the uncertainty over its eligibility for set off. The company has reported quarterly earnings of Rs. 350 lakhs and Rs. 150 lakhs respectively for the first**

**two quarters of financial year 2017-2018 and anticipates net earnings of Rs. 400 lakhs in the coming half year ended March 2018 of which Rs. 50 lakhs will be the loss in the quarter ended December, 2017. The tax rate for the company is 30% with a 10% surcharge. You are required to calculate the amount of tax expense to be reported for each quarter of financial year 2017-2018.** ***(RTP Nov 18)***

**Answer 4**

Estimated tax liability on annual income = [Income Rs. 900 lakhs – b/f losses Rs. 315 lakhs (90% of 350)] x 33% = 33% of Rs. 585 lakhs = Rs. 193.05 lakhs

As per para 29(c) of AS 25 Interim Financial Reporting, income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Thus, estimated weighted average annual income tax rate = Rs. 193.05 lakhs divided by Rs. 900 lakhs=21.45%

| Tax expense to be recognized in each quarter | Rs. in lakhs |
|---|---|
| Quarter I – Rs. 350 lakhs x 21.45% | 75.075 |
| Quarter II – Rs. 150 lakhs x 21.45% | 32.175 |
| Quarter III – (Rs. 50 lakhs) x 21.45% | (10.725) |
| Quarter IV – Rs. 450 lakhs x 21.45% | 96.525 |
| | 193.05 |

## Question 5

**An enterprise reports quarterly, estimates an annual income of ₹ 10 lakhs. Assume tax rates on 1st ₹ 5,00,000 at 30% and on the balance income at 40%. The estimated quarterly income are ₹ 75,000, ₹ 2,50,000, ₹ 3,75,000 and ₹ 3,00,000. Calculate the tax expense to be recognized in each quarter.** ***(RTP Nov 17, New SM)***

**Answer 5**

As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

| | | ₹ |
|---|---|---|
| Estimated Annual Income | (A) | 10,00,000 |
| Tax expense: | | |
| 30% on ₹ 5,00,000 | | 1,50,000 |
| 40% on remaining ₹ 5,00,000 | | 2,00,000 |
| | (B) | 3,50,000 |

**Weighted average annual income tax rate = B/A = 3,50,000/ 10,00,000= 35%**

| Tax expense to be recognized in each of the quarterly reports | | ₹ |
|---|---|---|
| Quarter I - | ₹ 75,000 x 35% | 26,250 |
| Quarter II - | ₹ 2,50,000 x 35% | 87,500 |
| Quarter III - | ₹ 3,75,000 x 35% | 1,31,250 |
| Quarter IV - | ₹ 3,00,000 x 35% | 1,05,000 |
| | ₹ 10,00,000 | 3,50,000 |

## Question 6

| | |
|---|---|
| **Estimated annual income** | **₹ 1 lakh** |
| **(inclusive of Estimated Capital Gains (earned in Quarter II)** | **₹ 20,000** |
| **The estimated income of each quarter is** | **₹ 25,000** |
| **Tax Rates:** | |
| **On Capital Gains** | **10%** |

| | |
|---|---|
| On other income: | |
| First ₹ 40,000 | 30% |
| Balance income | 40% |

**There is no difference between the estimated taxable income and the estimated accounting income. Calculate tax expense for each quarter and for the year.** ***(RTP May 18)***

**Answer 6**

**Tax Expense:**

On Capital Gains portion of annual income:

| | |
|---|---|
| 10% of ₹ 20,000 | ₹ 2,000 |
| On other income: 30% of ₹40,000 + 40% of ₹40,000 | ₹28,000 |
| Total: | ₹30,000 |

Weighted Average Annual Effective Tax Rate:

On Capital Gains portion of annual Income: (2,000 / 20,000) X 100 = 10%

On other income: (28,000/ 80,000) X 100 = 35%

When income of ₹ 25,000 for 2nd Quarter includes capital gains of ₹ 20,000, the tax expense for each quarter will be calculated as below:

| | | Income | Tax Expense | | |
|---|---|---|---|---|---|
| Quarter I | | ₹25,000 | 35% of ₹25,000 = | | ₹8,750 |
| Quarter II | Capital Gains: | ₹20,000 | 10% of ₹20,000 = | ₹2,000 | |
| | Other: | ₹5,000 | 35% of ₹5,000 = | ₹1,750 | ₹3,750 |
| Quarter III | | ₹25,000 | 35% of ₹25,000 = | | ₹8,750 |
| Quarter IV | | ₹25,000 | 35% of ₹25,000 = | | ₹8,750 |
| Total tax expense for the year | | | | | ₹30,000 |

## Question 7 LDR

**Antarbarti Limited reported a Profit Before Tax (PBT) of ₹ 4 lakhs for the third quarter ending 30-09-20X1. On enquiry you observe the following. Give the treatment required under AS 25:**

**(i) Dividend income of ₹ 4 lakhs received during the quarter has been recognized to the extent of ₹ 1 lakh only.**

**(ii) 80% of sales promotion expenses ₹ 15 lakhs incurred in the third quarter has been deferred to the fourth quarter as the sales in the last quarter is high.**

**(iii) In the third quarter, the company changed depreciation method from WDV to SLM, which resulted in excess depreciation of ₹ 12 lakhs. The entire amount has been debited in the third quarter, though the share of the third quarter is only ₹ 3 lakhs.**

**(iv) ₹ 2 lakhs extra-ordinary gain received in third quarter was allocated equally to the third and fourth quarter.**

**(v) Cumulative loss resulting from change in method of inventory valuation was recognized in the third quarter of ₹ 3 lakhs. Out of this loss ₹ 1 lakh relates to previous quarters.**

**(vi) Sale of investment in the first quarter resulted in a gain of ₹ 20 lakhs. The company had apportioned this equally to the four quarters.**

**Prepare the adjusted profit before tax for the third quarter.** ***(MTP 5 Marks Oct'17, SM)***

**Answer 7**

As per para 36 of AS 25 "Interim Financial Reporting", seasonal or occasional revenue and cost within a financial year should not be deferred as of interim date until it is appropriate to defer at the end of the enterprise's financial year. Therefore, dividend income, extra-ordinary gain, and gain on sale of investment received during 3rd quarter should be recognised in the 3rd quarter only. Similarly, sales promotion expenses incurred in the 3rd quarter should also be charged in the 3rd quarter only.

Further, as per AS 10, Property, Plant and Equipment, if there is change in the depreciation method, such a change should be accounted for as a change in accounting estimate in accordance with AS 5, Net Profit or Loss

for the Period, Prior Period Items and Changes in Accounting Policies, and applied prospectively. Therefore, no adjustment would be required due to change in the method of depreciation.
Accordingly, the adjusted profit before tax for the 3rd quarter will be as follows:

**Statement showing Adjusted Profit Before Tax for the third quarter**

| | **(₹ in lakhs)** |
|---|---|
| Profit before tax (as reported) | 4 |
| Add: Dividend income ₹ (4-1) lakhs | 3 |
| Excess depreciation charged in the 3rd quarter, due to change in the method | - |
| Extra ordinary gain ₹ (2-1) lakhs | 1 |
| Cumulative loss due to change in the method of inventory valuation should be applied retrospectively ₹ (3-2) lakhs | 1 |
| | 9 |
| Less: Sales promotion expenses (80% of ₹ 15 lakhs) | (12) |
| Gain on sale of investment (occasional gain should not be deferred) | (5) |
| Adjusted Profit before tax for the third quarter | (8) |

**Multiple Choice Questions (MCQs):**

1. **AS 25 mandates the following in relation to interim financial reports. *(SM)***
   (a) which entities should publish interim financial reports.
   (b) how frequently it should publish interim financial reports.
   (c) how soon it should publish after the end of interim period.
   (d) none of the above.

**Ans: (d)**

2. **The standard defines Interim Financial Report as a financial report for an interim period that contains a set of _________ financial statements. *(SM)***
   (a) Complete
   (b) Condensed
   (c) Financial statement similar to annual
   (d) Either complete or condensed

**Ans: (d)**

3. **ABC Limited has reported ₹ 85,000 as per tax profit in first quarter and expects a loss of ₹ 25,000 each in subsequent quarters. It has corporate tax rate slab of 20% on the first ₹ 20,000 earnings and 40% on all additional earnings. Calculate tax expenses that should report in first quarter interim financial report. *(SM)***
   (a) ₹ 17,000
   (b) ₹ 30,000
   (c) ₹ 2,000
   (d) AS 25 does not mandate to report tax expenses

**Ans: (a)**

4. **An entity prepares quarterly interim financial reports in accordance with AS 25. The entity is engaged in sale of mobile phones and normally 5% of customers claim on their warranty. The provision in the first quarter was calculated as 5% of sales to date, which was ₹10 million. However, in the second quarter, a fault was found and warranty claims were expected to be 10% for the whole of the year. Sales in the second quarter were ₹15 million. What would be the provision charged in the second quarter's interim financial statements? *(SM)***
   (a) ₹1 million
   (b) ₹ 2 million
   (c) ₹ 1.25 million
   (d) ₹ 1.5 million

**Ans: (b)**

# CHAPTER 5.1: AS–2 VALUATION OF INVENTORY

| CONCEPTS OF THIS CHAPTER | LDR Questions |
|---|---|
| • Definition of Inventory<br>• Measurement of Inventories<br>• Cost of Inventories<br>• Exclusions from Cost of Inventories<br>• Cost Formulas<br>• Techniques for Measuring Cost | Q 18<br>Q 20 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Applicability of AS 2 in accounting for inventories other than

- Work in progress arising under construction contracts, including directly related service contracts;
- Work in progress arising in the ordinary course of business of service providers
- Shares, debentures and other financial instruments held as stock in- trade;
- Producers' inventories of livestock, agricultural and forest products, and mineral resources are measured at net realizable value per industry practices.



### Determination of Cost of Inventories

➢ **Costs of purchase**- Purchase Price:

- Duties and other taxes (non-recoverable from the taxing authorities)
- Other expenditure directly Attributable to the acquisition
- Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase

➢ **Costs of conversion** (Explained below)

➢ **Other costs-** Costs incurred to bring the inventories to their present location and condition

### Joint products

| | |
|---|---|
| When the cost of conversion of each product is separately identifiable | Cost of each product is calculated on the basis of separate cost incurred. |
| When the cost of conversion of each product is not separately identifiable | Cost allocation is based on the relative sales value of each product at the point of identification or production completion. |

### Main product with a By-product

| | |
|---|---|
| • When the by-product is immaterial | By-product is measured at NRV and this value is deducted from the cost of the main product. |
| • When the by-product is material | By-product is treated as joint product and accordingly, the accounting is done. |

### Conversion Cost

| | | |
|---|---|---|
| Factory Overheads | 1. Fixed | • At Normal Capacity*<br>• At Actual Production** |
| | 2. Variable | • At Actual Production |
| Direct labour | | |
| Joint Cost | 1. Main/Joint*** | • Sale value at Separation<br>• Sale value at Completion |
| | 2. By Products | • NRV is deducted from cost of main joint products |

*When actual production is almost equal or lower than normal capacity.
** When actual production is higher than normal capacity.
*** Allocation at reasonable and consistent basis.

### Costs excluded from the cost of inventories and recognized as expenses

- Abnormal amounts of wasted materials, labour, or other production costs;
- Storage costs, unless the production process requires such storage;
- Administrative overheads that do not contribute to bringing the inventories to their present location and condition;
- Selling and distribution costs.

### Inventory Valuation Techniques

Inventory ordinarily interchangeable

- **Historical Cost Methods**
  - FIFO
  - Weighted Average
- **Non-Historical Cost Methods**
  - Retail Inventory / Adjusted selling price method
  - Standard Cost Method

Inventory not ordinarily interchangeable

- **Specific Identification Method** (applicable when individual items can be clearly identified and specific costs are attributed)

### Measurement of Inventories

| | | | |
|---|---|---|---|
| **Raw Materials** | At cost (if finished goods are sold at or above cost),otherwise at replacement cost | | |
| **Finished Goods and Work in progress** | Lower of | • Cost<br>• Net Realizable Value | Realizable Value less Selling Expenses less estimated cost of completion |

### Disclosure Requirements

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

## Question & Answers

### Question 1

**Rohan Pvt. Ltd., a wholesaler in agriculture products, has valued the inventory on Net Realizable Value on the ground that AS 2 does not apply to inventory of agriculture products.** ***(RTP May '22)***

**Answer 1**

AS 2 does not apply to producers of agricultural products but applies to traders in agricultural products. Hence AS 2 will apply to Rohan Pvt. Ltd. and it will have to value inventory at lower of cost or market value.

### Question 2

**Hello Ltd. purchased goods at the cost of ₹ 20 lakhs in October. Till the end of the financial year, 75% of the stocks were sold. The Company wants to disclose closing stock at ₹ 5 lakhs. The expected sale value is ₹ 5.5 lakhs and a commission at 10% on sale is payable to the agent. You are required to ascertain the value of closing stock?** ***(MTP 5 Marks Sep '22, RTP Nov'19)***

**Answer 2**

As per AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value.
In this case, the cost of inventory is ₹ 5 lakhs. The net realizable value is ₹ 4.95 lakhs (₹ 5.5 lakhs less cost to make the sale @ 10% of ₹ 5.5 lakhs). So, the closing stock should be valued at ₹ 4.95 lakhs.

### Question 3

**U.S.A Ltd. purchased raw material @ ₹ 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At**

**the end of the accounting year, company is having 10,000 kg of raw material in inventory. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realizable value of the raw material for valuation of inventories at the end of the year. However, replacement cost of raw material is ₹ 300 per kg. How will you value the inventory of raw material? *(MTP 5 Marks Oct '22)***

**Answer 3**

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the inventory of raw material at ₹ 30,00,000 (10,000 kg. @ ₹ 300 per kg.).

## Question 4

**Alpha Ltd. sells flavoured milk to customers; some of the customers consume the milk in the shop run by Alpha Limited. While leaving the shop, the consumers leave the empty bottles in the shop and the company takes possession of these empty bottles. The company has laid down a detailed internal record procedure for accounting for these empty bottles which are sold by the company by calling for tenders.**

**Keeping this in view:**

**Decide whether the inventory of empty bottles is an asset of the company;**

**If so, whether the inventory of empty bottles existing as on the date of Balance Sheet is to be considered as inventories of the company and valued as per AS 2 or to be treated as scrap and shown at realizable value with corresponding credit to 'Other Income'? *(RTP Nov '23, SM)***



**Answer 4**

As per the 'Framework on Presentation and Preparation of Financial Statements':

Tangible objects or intangible rights carrying probable future benefits, owned by an enterprise are called assets.

Alpha Ltd. sells these empty bottles by calling tende₹ It means further benefits are accrued on its sale.

Therefore, empty bottles are assets for the company.

As per AS 2, inventories are assets held for sale in the ordinary course of business.

Inventory of empty bottles existing on the Balance Sheet date is the inventory and Alpha Ltd. has detailed controlled recording and accounting procedure which duly signify its materiality.

Thus, inventory of empty bottles cannot be considered as scrap and should be valued as inventory in accordance with AS 2.

## Question 5

**The closing stock of finished goods (at cost) of a company amounted to ₹ 4,50,000. The following items were included at cost in the total:**

**(a) 100 coats, which had cost ₹ 2,200 each and normally sold for ₹ 4,000 each. Owing to a defect in manufacture their NRV was determined at 50% of their normal selling price.**

**(b) Shirts which had cost ₹ 50,000, their net realizable value at Balance sheet date was ₹ 55,000. Commission @ 10% on sales is payable to agents.**

**What should the inventory value be according to AS 2 after considering the above items? *(RTP Nov'22)***

**Answer 5**

**Valuation of closing stock**

| | ₹ |
|---|---|
| Closing stock at cost | 4,50,000 |
| Less: Adjustment for 100 coats (Working Note 1) | (20,000) |
| Value of inventory | 4,30,000 |

**Working Notes:**

1. Adjustment for Coats

| | |
|---|---|
| Cost included in Closing Stock | ₹2,20,000 |
| NRV of Coats | ₹2,00,000 |
| Adjustment to be made as NRV is less than cost | ₹20,000 |

2. No adjustment required for shirts as their NRV is more than their cost which was included in value of inventory.

## Question 6

**Vivitzu Ltd. is in the business of manufacturing computers. During the year ended 31st March, 2024, the company manufactured 550 computers. It has the policy of valuing finished stock of goods at a standard cost of ₹ 1.8 lakh per computer. The details of the costs are as under:**

| | (₹ in lakh) |
|---|---|
| Raw material consumed | 400 |
| Direct Labour | 250 |
| Variable production overheads | 150 |
| Fixed production overheads (including interest of ₹ 100 lakh) | 290 |

**Compute the value cost per computer for the purpose of closing stock.** ***(RTP Sep'24)***

**Answer 6**

As per para 9 of AS 2 'Valuation of Inventories', for inclusion in the cost of inventory, allocation of fixed production overheads is based on the normal capacity of the production facilities.

In this, case finished stock has been valued at a standard cost of ₹ 1.8 lakh per computer which incidentally synchronizes with the value computed on the basis of absorption costing as under:

| | | (₹ in lakh) |
|---|---|---|
| Materials | | 400 |
| Direct Labour | | 250 |
| Variable production overheads | | 150 |
| Fixed production overheads | 290 | |
| Less: Interest | (100) | 190 |
| Total cost | | 990 |

Number of computers produced = 550 computers (Assumed to be normal production)

Cost per computer ₹ 990 lakh / 550 computers = ₹ 1.80 lakh

## Question 7

(i) **"In determining the cost of inventories, it is appropriate to exclude certain costs and recognize them as expenses in the period in which they are incurred". Provide examples of such costs as per AS 2 'Valuation of Inventories'.** ***(MTP 2.5 Marks April 21 & Oct '23, RTP May'22,SM, PYP 4 Marks Sep'24)***

(ii) **X Limited purchased goods at the cost of ₹ 40 lakhs in October, 2020. Till March, 2021, 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 value of closing stock to be disclosed as at 31.3.2021.** ***(MTP 2.5 Marks April 21 & Oct '23)***

**Answer 7**

**(i)** As per AS 2 'Valuation of Inventories', certain costs are excluded from the cost of the inventories and are recognized as expenses in the period in which incurred. Examples of such costs are:

**(a)** Abnormal amount of wasted materials, Labour, or other production costs;

**(b)** Storage costs, unless those costs are necessary in the production process prior to a further production stage;

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

**(d)** Selling and distribution costs.

**(ii)** As per AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value. In this case, the cost of inventory is ₹10 lakhs. The net realizable value is 11,00,000 ₹90% = ₹ 9,90,000. So, the stock should be valued at ₹ 90,000.

## Question 8

**In the following cases, find the value of closing stock as per AS 2:**

**(i) Sonu is a retailer dealing in toys. During the year, he purchased items worth ₹ 1,47,000 and made a total sale ₹ 1,54,000. The average percentage of gross margin is 10% on cost. Opening stock of toys at cost was ₹ 20,000.**

**(ii) On 21st March, 2023, Mohan purchased 250 chairs at ₹ 300 each. The selling price of the chair is ₹ 400 each. Owing to a manufacturing defect, net realisable value of the whole lot of chair was determined at 70% of their normal selling price. No chairs were sold during the year. *(PYP 5 Marks Nov'23)***

**Answer 8**

(i) **Cost of closing inventory is shown below:**

| | ₹ |
|---|---|
| Sale value of opening stock and purchases | 1,83,700 |
| (₹ 20,000 + ₹1,47,000) x 1.10 | |
| Sales | (1,54,000) |
| Sale value of unsold stock | 29,700 |
| Less: Gross Margin (₹ 29,700 / 1.10) x 0.10 | (2,700) |
| Cost of closing inventory | 27,000 |

(ii)

| | |
|---|---|
| Closing stock at cost (250X ₹ 300) (i) | 75,000 |
| Net Realizable value of closing stock | 70,000 |
| (₹ 280* × 250) (ii) | |
| Value of closing stock [lower of (i) and (ii)] | 70,000 |

## Question 9

**Wooden Plywood Limited has a normal wastage of 5% in the production process. During the year 2023-24, the Company used 16,000 MT of Raw material costing ₹ 190 per MT. At the end of the year, 950 MT of wastage was in stock. The accountant wants to know how this wastage is to be treated in the books.**

**You are required to :**

**(1) Calculate the amount of abnormal loss.**

**(2) Explain the treatment of normal loss and abnormal loss in the context of AS-2.**
***(MTP 5 Marks Apr'24) (MTP 5 Marks, May '20, April '19, Oct '18, Old & New SM)(Same concept different figures PYP May'19 5 Marks)***

**Answer 9**

(i) As per AS 2 'Valuation of Inventories', abnormal amounts of wasted materials, labour and other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred. The normal loss will be included in determining the cost of inventories (finished goods) at the year end.

(ii)

| | |
|---|---|
| Material used | 16,000 MT @ ₹ 190=₹ 30,40,000 |
| Normal Loss (5% of 16,000 MT) | 800 MT (included in calculation of cost of inventories) |
| Net quantity of material | 15,200 MT |

(iii)

| | |
|---|---|
| Abnormal loss in quantity | (950-800) 150 MT |
| Abnormal loss | ₹30,000 |

Amount of ₹ 30,000 (Abnormal loss) will be charged to the Profit and Loss statement.

## Question 10

**In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in wastage of 300 MT. Cost per MT of input is ₹ 1,000. The entire quantity of waste and finished output is in stock at the year end. State with reference to Accounting Standard, how will you value the inventories in this case? What will be treatment for normal and abnormal waste? *(MTP 5 Marks, March '21, Apr'22 & April '23, Old & New SM)***

**Answer 10**

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

In this case, normal waste is 250 MT and abnormal waste is 50 MT. The cost of 250 MT will l be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste (50 MT x 1,052.6315 = ₹ 52,632) will be charged to the profit and loss statement.

Cost per MT (Normal Quantity of 4,750 MT) = 50,00,000 / 4,750 = ₹ 1,052.6315

Total value of inventory = 4,700 MT x ₹ 1,052.6315 = ₹ 49,47,368.

## Question 11

**On the basis of information given below, find the value of inventory (by periodic inventory method) as per AS 2, to be considered while preparing the Balance Sheet as on 31st March, 2017 on weighted Average Basis.**

**Details of Purchases:**

| Date of purchase | Unit(Nos.) | Purchase cost per unit (₹) |
|---|---|---|
| 01-03-2017 | 20 | 108 |
| 08-03-2017 | 15 | 107 |
| 17-03-2017 | 30 | 109 |
| 25-03-2017 | 15 | 107 |

| Date of Issue | Unit(Nos.) |
|---|---|
| 03-03-2017 | 10 |
| 12-03-2017 | 20 |
| 18-03-2017 | 10 |
| 24-03-2017 | 20 |

**Net realizable value of inventory as on 31st March, 2017 is ₹ 107.75 per unit. You are required to compute the value of Inventory as per AS 2.** ***(MTP March '19, 5 Marks, MTP March '18, 5 Marks, RTP May'22)***

**Answer 11**

Net Realizable Value of Inventory as on 31st March, 2017 = ₹ 107.75 x 20 units = ₹ 2,155

**Value of inventory as per Weighted Average basis.**

| **Total units purchased and total cost** | |
|---|---|
| 01.03.2017 | ₹ 108 x 20 units = ₹ 2160 |
| 08.3.2017 | ₹ 107 x 15 units = ₹ 1605 |
| 17.03.2017 | ₹ 109 x 30 units = ₹ 3270 |
| 25.03.2017 | ₹ 107 x 15 units = ₹ 1605 |
| Total | 80 units = ₹8640 |
| Weighted Average Cost | = ₹ 8640/80 units = ₹ 108 |
| Total cost | = ₹ 108 x 20 units = ₹ 2,160 |

Value of inventory to be considered while preparing Balance Sheet as on 31st March, 2017 is, Cost or Net Realizable value whichever is lower i.e. ₹ 2,155.

## Question 12

**On 31st March 2020, a business firm finds that cost of a partly finished unit on that date is ₹ 430. The unit can be finished in 2020-21 by an additional expenditure of ₹ 310. The finished unit can be sold for ₹ 750 subject to payment of 2% brokerage on selling price. The firm seeks your advice regarding the amount at which the unfinished unit should be valued as at 31st March, 2020 for preparation of final accounts. Assume that the partly finished unit cannot be sold in semi-finished form and its NRV is zero without processing it further.** ***(RTP Nov, 21) (Same concept different figures RTP May 19)( SM)***

**Answer 12**

**Valuation of unfinished unit**

| | ₹ |
|---|---|
| Net selling price | 750 |

| | |
|---|---|
| Less: Estimated cost of completion | (310) |
| | 440 |
| Less: Brokerage (2 % of 750) | (15) |
| Net Realizable Value | 425 |
| Cost of inventory | 430 |
| Value of inventory (Lower of cost and net realizable value) | 425 |

## Question 13

**From the following information provided by XYZ Limited you are required to compute the closing inventory:**

| | |
|---|---|
| **Raw Material P** | |
| **Closing balance** | **600 units** |
| | **₹ per unit** |
| **Cost price including GST** | **250** |
| **Input tax credit available** | **20** |
| **Freight inward** | **30** |
| **Handling charges** | **15** |
| **Replacement cost** | **180** |
| | |
| **Finished goods Q** | |
| **Closing Balance** | **1500 units** |
| | **₹ per unit** |
| **Material Consumed** | **250** |
| **Direct Labour** | **70** |
| **Direct Overheard** | **30** |

**Total fixed overhead for the year was ₹ 3,00,000 on a normal capacity of 30,000 units while actual production has been of 25,000 units.**

**Calculate the value of closing stock, when**

**(i) Net realizable value of the finished good Q is ₹ 450 per unit.**

**(ii) Net Realizable value of the Finished Good Q is ₹ 340 per unit.** ***(MTP Oct '21, 5 marks)***



**Answer 13**

(i) **When Net Realizable Value of the Finished Good Q is ₹ 450 per unit**

**Value of Closing Stock:**

| | Valuation Base | Qty. | Rate (₹) | Amount (₹) |
|---|---|---|---|---|
| **Raw Material P** | **Cost** | **600** | **275** | **1,65,000** |
| **Finished Good Q** | **Cost** | **1,500** | **360** | **5,40,000** |
| **Total value of closing stock** | | | | **7,05,000** |

**(ii) When Net Realizable Value of the Finished Good Q is ₹ 340 per unit**

Since NRV of finished goods Q is less than its cost i.e., ₹ 360 (Refer W.N.), raw material P is to be valued at replacement cost and finished goods is to be valued at NRV.

**Value of Closing Stock:**

| | Valuation Base | Qty. | Rate (₹) | Amount (₹) |
|---|---|---|---|---|
| Raw material P | Replacement cost | 600 | 180 | 1,08,000 |
| Finished good Q | Net Realizable Value | 1,500 | 340 | **5,10,000** |
| Total value of closing stock | | | | **6,18,000** |

**Working Note:**

Statement showing calculation of cost of raw material P and finished good Q

| **Raw Material P** | ₹ |
|---|---|
| Cost Price (250-20) | 230 |
| Add: Freight Inward | 30 |
| Handling charges | 15 |

| | |
|---|---|
| Cost | 275 |
| **Finished Goods Q** | ₹ |
| Materials consumed | 250 |
| Direct Labour | 70 |
| Variable overheads | 30 |
| | 10 |
| | 360 |

## Question 14

**The inventory of Wivisu Ltd. as on 31st March, 2020 comprises of Product – A: 200 units and Product – B: 800 units.**

**Details of cost for these products are:**

**Product – A: Material cost, wages cost and overhead cost of each unit are ₹ 40,₹ 30 and ₹ 20 respectively, each unit is sold at ₹ 110, selling expenses amounts to 10% of selling costs.**

**Product – B: Material cost and wages cost of each unit are ₹ 45 and ₹ 35 respectively and normal selling rate is ₹ 150 each, however due to defect in the manufacturing process 800 units of Product-B were expected to be sold at ₹ 70.**

**You are requested to value closing inventory according to AS 2 after considering the above.** ***(RTP May '21)***

**Answer 14**

According to AS 2 'Valuation of Inventories', inventories should be valued at the lower of cost and net realizable value.

**Product – A**

| | | |
|---|---|---|
| Material cost | ₹ 40 x 200 = 8,000 | |
| Wages cost | ₹ 30 x 200 = 6,000 | |
| Overhead | ₹ 20 x 200 = 4,000 | |
| Total cost | | ₹ 18,000 |
| Realizable value [200 x (110-11)] | | ₹ 19,800 |
| Hence inventory value of Product -A | | ₹ 18,000 |

**Product – B**

| | | |
|---|---|---|
| Material cost | ₹ 45 x 800 = 36,000 | |
| Wages cost | ₹ 35 x 800 = 28,000 | |
| Total cost | | ₹ 64,000 |
| Realizable value (800 x 70) | | ₹ 56,000 |
| Hence inventory value of Product-B | | ₹ 56,000 |
| Total Value of closing inventory i.e. Product A + Product B (18,000+ 56,000) | | ₹ 74,000 |

## Question 15

**An enterprise ordered 20,000 KG of certain material at ₹ 110 per unit. The purchase price includes GST ₹ 12 per KG, in respect of which full input tax credit (ITC) is admissible. Freight incurred amounted to ₹ 1,17,600. Normal transit loss is 2%. The enterprise actually received 19,500 KG and consumed 18,000 KG of the material.**

**(i) You are required to calculate cost of material per KG;**

**(ii) Allocation of material cost.** ***(RTP May'23) (SM)***

**Answer 15**

**Calculation of Normal cost per Kg.**

| | ₹ |
|---|---|
| Purchase price (20,000 Kg. x ₹ 110) | 22,00,000 |
| Less: Input Tax Credit (20,000 Kg. x ₹ 12) | (2,40,000) |
| | 19,60,000 |
| Add: Freight | 1,17,600 |
| A. Total material cost | 20,77,600 |
| B. Number of units normally received = 98% of 20,000 Kg. | Kg. 19,600 |

| | |
|---|---|
| C. Normal cost per Kg. (A/B) | 106 |

**Allocation of material cost**

| | Kg. | ₹/Kg. | ₹ |
|---|---|---|---|
| Materials consumed | 18,000 | 106 | 19,08,000 |
| Cost of inventory | 1,500 | 106 | 1,59,000 |
| Abnormal loss | 100 | 106 | 10,600 |
| Total material cost | 19,600 | 106 | 20,77,600 |

Note: Abnormal losses are recognized as separate expense.

## Question 16

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

**The expected production for the year was 15,000 kg of the finished product. Due to fall in market demand the sales price for the finished goods was ₹ 20 per kg and the replacement cost for the raw material was ₹ 9.50 per kg on the closing day. You are required to calculate the closing inventory as on that date. *(MTP 5 Marks March '23) (RTP May 20)***



**Answer 16**

**Calculation of cost for closing inventory**

| Particulars | ₹ |
|---|---|
| Cost of Purchase (10,200 x 10) | 1,02,000 |
| Direct Labour | 76,500 |
| Fixed Overhead $\frac{75000 \times 10,200}{15,000}$ | 51,000 |
| Cost of Production | 2,29,500 |
| Cost of closing inventory per unit (2,29,500/10,200) | ₹ 22.50 |
| Net Realisable Value per unit | ₹ 20.00 |

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

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

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

## Question 17

**SM Enterprises is a leading distributor of petrol. A detailed inventory of petrol in hand is taken when the books are closed at the end of each month. For the month ending June 2021 following information is available:**

(i) **Sales for the month of June 2021 was ₹30,40,000.**

(ii) **General overheads cost ₹4,00,000.**

(iii) **Inventory at beginning 10,000 liters @ ₹ 92 per liter.**

(iv) **Purchases-June 1, 2021, 20,000 liters @ ₹ 90 per liter, June 30, 2021, 10,000 liters @ ₹ 95 per liter.**

(v) **Closing inventory 13,000 lite₹**

**You are required to compute the following by FIFO method as per AS 2:**

(i) **Value of Inventory on 30th June, 2021.**
(ii) **Amount of cost of goods sold for June,2021.**
(iii) **Profit/Loss for the month of June,2021.** ***(PYP 5 Marks May '22)***

**Answer 17**

| | ₹ |
|---|---|
| Cost of closing inventory for 13,000 liters as on 30th June 2021 | |
| 10,000 liters @ ₹ 95 | 9,50,000 |
| 3,000 liters @ ₹ 90 | 2,70,000 |
| Value of inventory (determined at cost in absence of NRV) | - |
| | **12,20,000** |
| Calculation of cost of goods sold | |
| Opening inventories (10,000 liters @ ₹ 92) | 9,20,000 |
| Purchases June – 1 (20,000 liters @ ₹ 90) | 18,00,000 |
| June – 30 (10,000 liters @ 95) | **9,50,000** |
| | 36,70,000 |
| Less: Closing inventories<br>Cost of Goods Sold | **(12,20,000)**<br>**24,50,000** |
| | |
| Calculation of Profit | |
| Sales (Given) (A) | **30,40,000** |
| Cost of Goods Sold | 24,50,000 |
| Add: General Overheads | **4,00,000** |
| Total Cost (B) | **28,50,000** |
| Profit (A-B) | **1,90,000** |



## Question 18

LDR

**Following information of Sarah Limited is given:**
**Sarah Limited uses Raw Material 'A' for production of production of Finished Goods *'B'***

| | |
|---|---|
| **Closing balance of Raw Material 'A' in units on 31st March,2022** | **750** |
| | **Price Per Unit in ₹** |
| **Cost Price** | **150** |
| **Freight inward** | **10** |
| **Replacement Cost** | **152** |
| **Closing balance of Finished Good 'B' in units on 31st March,2022** | **1,600** |
| | **Price Per Unit in ₹** |
| **Material Consumed** | **225** |
| **Direct Labour** | **75** |
| **Direct variable overhead** | **60** |

**Total Fixed Overheads amounts to ₹ 1,00,000 on normal capacity of 20,000 units.**
**You are required to calculate the value of Closing Stock of Raw materials and Closing Stock of Finished Goods, as on 31st March, 2022, as per AS 2, when selling price of Finished Goods 'B' is ₹ 360 per unit.** ***(PYP 5 Marks, Nov '22)***

**Answer 18**

| **Raw Material A** | ₹ |
|---|---|
| Cost Price | 150 |
| Add: Freight Inward | 10 |
| Cost per unit | 160 |
| Replacement cost per unit of raw material | |

As per AS 2 (Revised) "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value. Materials and other supplies held for use in the production of inventories are written down below cost if the selling price of finished product containing the material does not exceed the cost of the finished product. In the given case, net realizable value of the Product 'B' (Finished Goods) is ₹ 360 per unit which is less than its cost ₹ 365 per unit. Raw Material is to be valued at replacement cost.

Value of the closing stock of raw material on 31/03/2022 would be ₹ 1,14,000 (750 units X ₹152 per unit).

| **Finished Goods B** | ₹ |
|---|---|
| Materials consumed | 225 |
| Direct Labor | 75 |
| Direct Variable overheads | 60 |
| Fixed overheads (₹ 1,00,000/20,000 units) | 5 |
| Cost per unit | **365** |
| Net realizable value per unit | **360** |

As per AS 2 (Revised) "Valuation of Inventories", the inventories are to be valued at lower of cost or net realizable value. Hence, Finished Goods are to be valued at NRV since NRV is less than the cost.

Value of the closing stock of Finished goods as on 31/03/2022 would be ₹ 5,76,000 (1,600 units X ₹ 360 per unit).

## Question 19

**Mr. Jatin gives the following information relating to the items forming part of the inventory as on 31.03.2019. His enterprise produces product P using Raw Material X.**

**(i) 900 units of Raw Material X (purchases @ ₹ 100 per unit). Replacement cost of Raw Material X as on 3103.2019 is ₹ 80 per unit**

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

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

**Expected selling price of product P is ₹280 per unit, subject to a payment of 5% brokerage on selling price. Determine how each item of inventory will be valued as on 31.03.2019. Also calculate the value of total Inventory as on 31.03.2019.** ***(PYP 5 Marks Jan '21) (Sam concept different figures PYP 5 Marks Nov'19, MTP Oct'19 5 Marks, SM) (MTP 5 Marks Sep '23)***

**Answer 19**

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at cost or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. In the given case, selling price of product P is ₹ 266 and total cost per unit for production is ₹ 295.

Hence the valuation will be done as under:

**(i)** 900 units of raw material X will be written down to replacement cost as market value of finished product is less than its cost, hence valued at ₹ 80 per unit.

**(ii)** 400 units of partly finished goods will be valued at 216 per unit i.e., lower of cost (₹ 245) or Net realizable value ₹ 216 (Estimated selling price ₹ 266 per unit less additional cost of ₹ 50).

**(iii)** 800 units of finished product P will be valued at NRV of ₹ 266 per unit since it is lower than cost ₹ 295.

**Valuation of Total Inventory as on 31.03.2019:**

| | Units | Cost (₹) | NRV/Replacement cost | Value = unit's x cost or NRV whichever is less (₹) |
|---|---|---|---|---|
| Raw material X | 900 | 100 | 80 | 72,000 |
| Partly finished goods | 400 | 245 | 216 | 86,400 |
| Finished goods P | 800 | 295 | 266 | **2,12,800** |
| Value of Inventory | | | | **3,71,200** |

| Question 20 | LDR |
|---|---|

**Joy Ltd. purchased 20,000 kilograms of Raw Material @ ₹ 20 per kilogram during the year 2020-21. They have furnished you with the following further information for the year ended 31st March, 2021:**

| Particulars | Units | Amount (₹) |
|---|---|---|
| Opening Inventory: | | |
| Finished Goods | 2,000 | 1,00,000 |
| Raw Materials | 2,200 | 44,000 |
| Direct Labour | | 3,06,000 |
| Fixed Overheads | | 3,00,000 |
| Sales | 20,000 | 11,20,000 |
| Closing Inventory: | | |
| Finished Goods | 2,400 | |
| Raw Materials | 1,800 | |

**The plant has a capacity to produce 30,000 Units of finished product per annum. However, the actual production of finished products during the year 2020-21 was 20,400 Units. Due to a fall in the market demand, the price of the finished goods in which the raw material has been utilized is expected to be sold @ ₹ 40 per unit. The replacement cost of the raw material was ₹ 19 per kilogram. You are required to ascertain the value of closing inventory as at 31st March, 2021 as per AS 2. *(PYP July'21, 5 Marks)***

**Answer 20**

**Statement Showing the Computation of Value of Closing Inventory Value of Closing Finished Goods**

| Particulars | Amount (₹) |
|---|---|
| Cost of Raw Material consumed (20,400 units X ₹ 20 per kg) | 4,08,000 |
| Direct Labour | 3,06,000 |
| Fixed Overheads (3,00,000/30,000 x 20,400) | 2,04,000 |
| Cost of Production | 9,18,000 |
| Cost of Closing Inventory of Finished Goods per unit (₹ 9,18,000/20,400) | 45 |
| Net Realizable Value (NRV) per unit | 40 |

Since net realizable value is less than cost, closing inventory of Finished Goods will be valued at ₹ 40 per unit

Value of Closing Raw Materials as NRV of finished goods is less than its cost, the relevant raw material will be valued at its replacement cost, which is the best available measure of its NRV

i.e., @ ₹ 19 per kg. Therefore, value of closing inventory would be as under:

| | |
|---|---|
| Finished Goods 2,400 units @ ₹ 40/- per unit | ₹ 96,000 |
| Raw Materials 1,800 kg @ ₹ 19/- per kg | ₹ 34,200 |
| Total | ₹ 1,30,200 |

**Working Note:**

**Calculation of raw material consumed during the year**

| Particulars | Unit (Kg) |
|---|---|
| Opening Inventory | 2,200 |
| Purchases | 20,000 |
| Less: Closing Inventory | (1,800) |
| Raw Material Consumed | 20,400 |

## Multiple Choice Questions (MCQs)

**1. Which item of inventory is under the scope of AS 2 (Revised)? *(SM)***

(a) WIP arising under construction contracts
(b) Raw materials
(c) Shares
(d) Debentures held as stock in trade.

**Ans: (b)**

2. **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 *(SM)***
   (a) sold at or above cost.
   (b) sold above cost.
   (c) sold less than cost.
   (d) sold at market value(where market value is more than cost).

**Ans: (a)**

3. **Identify the statement(s) which is/are incorrect. *(SM)***
   (a) Storage costs which is a necessary part of the production process isincluded in inventory valuation.
   (b) Administration overheads are never included in inventory valuation.
   (c) Full amount of variable production overheads incurred are included in inventory valuation.
   (d) Administration overheads are always included in inventory valuation.

**Ans: (b)**

4. **In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Which of the following is not an example of such costs: *(MTP 2 Marks July'24)***
   (a) Abnormal amounts of wasted materials, labour, or other production costs;
   (b) Storage costs, unless the production process requires such storage;
   (c) Raw Material cost
   (d) Selling and distribution costs.

**Ans: (c)**

5. **The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned using following cost formula (Chapter 5.1 AS 2- Valuation of Inventory) (MTP 2 Marks Aug'24)**
   (a) By specific identification of their individual costs
   (b) First-in, First-out (FIFO) Method
   (c) Weighted average cost formula
   (d) 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.

**Ans: (a)**

6. **As per AS 2, Inventories include materials awaiting use in production process, what should be included in Inventories from the following: (RTP Sep '24)**
   (a) Secondary Packing material required for transporting and forwarding the material.
   (b) Spare parts, servicing equipment and standby equipment
   (c) Primary packing material which is essential to bring an item of inventory to its saleable condition, for example, bottles, cans etc., in case of food and beverages industry.
   (d) Publicity material

**Ans: (c)**

7. **All of the following costs are excluded while computing value of inventories except? (MTP 2 Marks Mar'24, SM)**
   (a) Selling and Distribution costs
   (b) Allocated fixed production overheads based on normal capacity.
   (c) Abnormal wastage
   (d) Storage costs (which is necessary part of the production process)

**Ans: (b)**

A

# CHAPTER 5.2: AS–10 PROPERTY, PLANT AND EQUIPMENT

| CONCEPTS OF THIS CHAPTER | | LDR Questions |
|---|---|---|
| • Definition of PPE<br>• Recognition Criteria for PPE<br>• Subsequent Costs<br>• Measurement at Recognition<br>• Elements of Cost<br>• Measurement after Recognition<br>• Cost Model | • Revaluation Model<br>• Depreciation:<br>• Depreciable Amount & Useful Life<br>• Depreciation Method<br>• Retirement of PPE<br>• Derecognition<br>• Disclosure Requirements | LDR<br>LDR Questions<br>Q 16<br>Q 17 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

### AS 10 (Revised) Not applicable to

- Biological Assets* (other than Bearer Plants) related to agricultural activity
- Wasting Assets including Mineral rights, Expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non regenerative resources

### PPE (Tangible Items)

| | |
|---|---|
| Condition 1: Held for | • Use in Production or Supply of Goods or Services<br>• For Rental to others<br>• For Administrative purposes |
| Condition 2: Expected to be | • Used for more than 12 months |

### Recognition Criteria for PPE

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

| | |
|---|---|
| • It is probable that future economic benefits associated with the item will flow to the enterprise, and | • The cost of the item can be measured reliably |

***Notes:***

- Insignificant items (e.g., molds, tools, dies) may be **aggregated** for assessment.
- Enterprises may **expense immaterial items** instead of recognizing them as PPE.

### Cost of an Item of PPE

| | |
|---|---|
| Includes | • Purchase Price<br>• Any Directly Attributable Costs<br>• Decommissioning, Restoration and similar Liabilities |
| Excludes | • Costs of opening a new facility or business (Such as, Inauguration costs)<br>• Costs of introducing a new product or service (including costs of advertising and promotions)<br>• Costs of conducting business in a new location or with a new class of customer<br>• Administration and other general overhead costs |

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

- 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
- Initial operating losses, such as those incurred while demand for the output of an item builds up. And
- Costs of relocating or reorganizing part or all of the operations of an enterprise

| | | | |
|---|---|---|---|
| **Measurement after Recognition** | Cost model | PPE carried at | Cost Less Any Accumulated Depreciation and Any Accumulated Impairment losses |
| | Revaluation Model | PPE carried at a revalued amount | Whose fair value can be measured reliably. |

**Revaluation - Increase or Decrease**

| | | | |
|---|---|---|---|
| **Revaluation** | Increase | Credited directly to owners' interests under the heading of Revaluation surplus | |
| | | Exception: When it is subsequently Increased (Initially Decreased) | Recognized in the Statement of Profit and Loss only to the extent it reverses a prior revaluation decrease of the same asset. |
| | Decrease | Charged to the Statement of profit and loss | |
| | | Exception: When it is subsequently Decreased (Initially Increased) | A decrease is debited to Revaluation Surplus if a credit balance exists for that asset |

**Methods of Depreciation**

| | |
|---|---|
| Straight-line Method | Results in a constant charge over the useful life if the residual value of the asset does not change. |
| Diminishing Balance Method | Results in a decreasing charge over the useful life |
| Units of Production Method | Results in a charge based on the expected use or output. |

**De-Recognition**

| | | |
|---|---|---|
| **Derecognition of Carrying amount PPE:** | • On disposal – By sale – By entering into a finance lease, or – By donation, | |
| | • When no future economic benefits are expected from its use or disposal | |
| | • Accounting Treatment | Gains or losses from PPE de-recognition are recorded in the Statement of Profit and Loss, except when AS 19 (Leases) applies. Calculation: Gain/Loss = Net disposal proceeds (if any) - Carrying amount. |

**<u>Question & Answers</u>**

## Question 1

**A Ltd. has incurred the following costs. Determine if the following costs can be added to the invoiced purchase price and included in the initial recognition of the cost of the item of property, plant and equipment:**

1. **Import duties paid**
2. **Shipping costs and cost of road transport for taking the machinery to the factory**
3. **Insurance for the shipping**
4. **Inauguration costs for the factory**
5. **Professional fees charged by consulting engineer for the installation process**
6. **Costs of advertising and promotional activities**
7. **Administration and other general overhead costs**
8. **Cost of site preparation.** ***(RTP May '22)***

**Answer 1**

Included in Cost: Point no. 1,2,3,5,8

Excluded from Cost: Point no. 4,6,7

## Question 2

**Mohan Ltd. 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:**

**Setup costs of Rs. 5,00,000 to install machinery in the new location.**

**Rent of Rs. 15,00,000**

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

**Mohan Ltd. wants to seek your guidance as whether these costs can be capitalized into the cost of the new building. You are required to advise in line with AS 10 "Property, Plant and Equipment".**

***(MTP 5 Marks May 20, April 21, March 18, Oct '18 & Apr'22 & Oct '22)*** **(SM)**

**Answer 2**

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 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 reducing or reorganizing the operations of the accompany. These costs do not meet that requirement of AS 10 "Property, Plant and Equipment" and cannot, therefore, be capitalized.

## Question 3

(i) **Entity A carried plant and machinery in its books at ₹ 2,00,000 which were destroyed in a fire. These machines were insured 'New for old' and were replaced by the insurance company with new machines of fair value ₹ 20,00,000. The old destroyed machines were acquired by the insurance company and the company did not receive any cash compensation. State, how Entity A should account for the same?** ***(MTP 2.5 Marks Oct 20, Mar 22)***

(ii) **Omega Ltd, a supermarket chain, is renovating one of its major stores. The store will have more available space for 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. Decide whether Omega Ltd. can capitalize the remodeling cost or not as per provisions of AS 10 "Property plant & Equipment".** ***(MTP 2.5 Marks Oct 20, Oct'19, Mar 22)***

**Answer 3**

**(i)** 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 on Property, Plant and Equipment. Entity A should separately recognize a receivable and a gain in the income statement resulting from the insurance proceeds once receipt is virtually certain. The receivable should be measured at the fair value of assets provided by the insurer.

**(ii)** The expenditure in remodeling the store will create future economic benefits (in the form of 15% of increase in sales). Moreover, the cost of remodeling can be measured reliably, therefore, it should be capitalized in line with AS 10.

## Question 4

**Wivi Tsu Ltd. has entered into a binding agreement with XYZ Ltd. to buy a custom-made machine amounting to Rs. 4,00,000. As on 31st March, 2020 before delivery of the machine, Wivi Tsu Ltd. had to change its method of production. The new method will not require the machine ordered and so it shall be scrapped after delivery. The expected scrap value is 'NIL'. Show the treatment of machine in the books of Wivi Tsu Ltd.** ***(MTP 5 Marks Oct 20, Oct 18, Mar 22, Aug 18, Oct'19)***

**Answer 4**

A liability is recognized when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, Wivi Tsu Ltd. should recognize a liability of ₹ 4,00,000 payable to XYZ Ltd. When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognized as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognized as an expense. Hence Wivi Tsu Ltd. should charge the amount of ₹ 4,00,000 (being loss due to change in production method) to Profit and loss statement and record the corresponding liability (amount payable to XYZ Ltd.) for the same amount in the books for the year ended 31st March, 2020.

## Question 5

**Neon Enterprise operates a major chain of restaurants located in different cities. The company has acquired a new restaurant located at Chandigarh. The new-restaurant requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the restaurant will be closed.**

**Management has prepared the following budget for this period – Salaries of the staff engaged in preparation of restaurant before its opening Rs. 7,50,000 Construction and remodelling cost of restaurant Rs. 30,00,000. Explain the treatment of these expenditures as per the provisions of AS 10 "Property, Plant and Equipment". *(MTP 5 Marks March '21, Sep '22 & Oct '23) (PYP Nov'18, 5 Marks)***

**Answer 5**

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 remodeling 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 remodeling expenditure amounting Rs. 30,00,000 and thus the expenditure should be considered part of the asset.

However, the cost of salaries of staff engaged in preparation of restaurant Rs. 7,50,000 before its opening are in the nature of operating expenditure that would be incurred if the restaurant was open and these costs are not necessary to bring the restaurant to the conditions necessary for it to be capable of operating in the manner intended by management. Hence, Rs. 7,50,000 should be expensed.

## Question 6

**You are required to give the correct accounting treatment for the following in line with provisions of AS 10:**

**(a) Trozen Ltd. operates a major chain of supermarkets all over India. It acquires a new store in Pune which requires significant renovation expenditure. It is expected that the renovations will be done in 2 months during which the store will be closed. The budget for this period, including expenditure related to construction and remodeling costs (Rs. 18 lakhs), salaries of staff (Rs. 2 lakhs) who will be preparing the store before its opening and related utilities costs (Rs. 1.5 lakhs), is prepared. The cost of salaries of the staff and utilities are operating expenditures that would be incurred even after the opening of the supermarket. What will the treatment of all these expenditures in the books of accounts?**

**(b) Wivi Tsu Ltd is setting up a new refinery outside the city limits. In order to facilitate the construction of the refinery and its operations, Wivi Tsu Ltd. is required to incur expenditure on the construction/development of railway siding, road and bridge. Though Wivi Tsu Ltd. incurs the expenditure on the construction/development, it will not have ownership rights on these items and they are also available for use to other entities and public at large. Can Wivi Tsu Ltd. capitalize expenditure incurred on these items as property, plant and equipment (PPE)? *(RTP May '21)***

**Answer 6**

(a) Trozen Ltd. should capitalize the costs of construction and remodeling 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. The supermarket cannot be opened without incurring the remodeling expenditure. Therefore, this construction and remodeling expenditure of Rs. 18 lakhs should be considered as part of the cost of the asset. However, the cost of salaries of the staff Rs. 2 lakh and utilities cost Rs. 1.5 lakh are operating expenditures that would be incurred even after the opening of the supermarket. Therefore, 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 the management and should be expensed.

(b) AS 10 states that the cost of an item of property, plant and equipment shall be recognized as an asset if, and only if:

   (a) it is probable that future economic benefits associated with the item will flow to the entity; and

   (b) the cost of the item can be measured reliably.

   Further, the standard provides that the standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. The cost of an item of property, plant and equipment comprise 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.

   In the given case, railway siding, road and bridge are required to facilitate the construction of the refinery and for its operations. Expenditure on these items is required to be incurred in order to get future economic benefits from the project as a whole which can be considered as the unit of measure for the purpose of capitalization of the said expenditure even though the company cannot restrict the access of others for using the assets individually. It is apparent that the aforesaid expenditure is 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.

In view of this, even though Wivi Tsu Ltd. may not be able to recognize expenditure incurred on these assets as an individual item of property, plant and equipment in many cases (where it cannot restrict others from using the asset), expenditure incurred may be capitalized as a part of overall cost of the project. From this, it can be concluded that, in the given case the expenditure incurred on these assets, i.e., railway siding, road and bridge, should be considered as the cost of constructing the refinery and accordingly, expenditure incurred on these items should be allocated and capitalized as part of the items of property, plant and equipment of the refinery.

## Question 7

**RS Ltd. has acquired a heavy plant at a cost of ₹ 2,00,00,000. The estimated useful life is 10 years. At the end of the 2nd year, one of the major components i.e., the Boiler has become obsolete (which was acquired at price of ₹ 50,00,000) and requires replacement, as further maintenance is uneconomical. The remainder of the plant is perfect and is expected to last for next 8 years. The cost of a new boiler is ₹ 60,00,000. Can the cost of the new boiler be recognised as an asset, and, if so, what should be the carrying value of the plant at the end of second year? *(RTP Nov'22)***

### Answer 7

Recognition of Asset: The new boiler will produce economic benefits to RS Ltd., and the cost is measurable. Hence, the item should be recognized as an asset. The cost old boiler should be de-recognized and the new boiler will be added.

**Statement showing cost of new boiler and machine after year 2**

| | |
|---|---|
| Original cost of plant | ₹ 2,00,00,000 |
| Less: Accumulated depreciation [(2,00,00,000 /10) x 2] | **₹ 40,00,000** |
| Carrying value of the plant after two years | ₹ 1,60,00,000 |
| Less: Current Cost of Old Boiler to be derecognized | |
| Less: WDV of Boiler (replaced) after 2 years (50,00,000/10 x 8) | **₹ 40,00,000** |
| | ₹ 1,20,00,000 |
| Add: Cost of new Boiler to be recognized | **₹ 60,00,000** |
| Revised carrying amount of Plant | ₹ 1,80,00,000 |

## Question 8

**A property costing ₹ 10,00,000 is bought on 1.4.2020. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 25 years. The estimated residual value in 25 years' time, based on current year prices, is:**

**Case (a) ₹ 10,00,000**

**Case (b) ₹ 9,00,000**

**You are required to compute the amount of depreciation charged for the year ended 31.3.2021.**
***(RTP Nov 21, SM)***

### Answer 8

**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 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 ₹ 4,000 [{10,00,000 – 9,00,000} ÷ 25].

## Question 9

**(i) A Limited has contracted with a supplier to purchase machinery which is to be installed at its new plant in four months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying foundations were ₹ 2,10,000. These activities were supervised by an Architect during the entire period, who is employed for this purpose at a salary of ₹ 35,000 per month. The machinery was purchased for ₹ 1,27,50,000 and a sum of ₹ 2,12,500 was incurred towards transportation charges to bring the machinery to the plant site. An Engineer was appointed at a fee of ₹ 37,500 to supervise the installation of the machinery at the plant site. You are required to ascertain the amount at which the machinery should be capitalized in the books of A Limited. *(PYP 2.5 Marks Jul'21)***

**(ii) B Limited, which operates a major chain of retail stores, has acquired a new store location. The new location requires substantial renovation expenditure. Management expects that the renovation will last for 4 months during which the store will be closed. Management has prepared the budget for this period including expenditure related to construction and re-modelling costs, salary of staff who shall be preparing the store before its opening and related utilities cost. How would such expenditure be treated in the books of B Limited? *(PYP 2.5 Marks, July,21, SM)***

**Answer 9**

(i) Statement Showing the Computation of the amount at which the Machinery should be capitalized in the books of A Limited

| Particulars | | Amount (₹) |
|---|---|---|
| Purchase cost of machinery | Given | 1,27,50,000 |
| Add: Site Preparation Cost | Given | 2,10,000 |
| Architect's Salary | Specific / Attributable overheads for 4 months (₹ 35,000 x 4) | 1,40,000 |
| Initial Delivery Cost | Transportation | 2,12,500 |
| Professional Fees for Installation | Engineer's Fees | 37,500 |
| Total Cost of Machinery to be capitalized | | 1,33,50,000 |

(ii) Management should capitalize the costs of construction and remodeling the store, 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 store cannot be opened without incurring the remodeling 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 store 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 10

**Wivi Tsu Ltd. is installing a new plant at its production facility. It has incurred these costs:**

| | |
|---|---|
| **Cost of the plant (cost per supplier's invoice plus taxes)** | **Rs. 25,00,000** |
| **Initial delivery and handling costs** | **Rs. 2,00,000** |
| **Cost of site preparation** | **Rs. 6,00,000** |
| **Consultants used for advice on the acquisition of the plant** | **Rs. 7,00,000** |
| **Interest charges paid to supplier of plant for deferred credit** | **Rs. 2,00,000** |
| **Estimated dismantling costs to be incurred after 7 years** | **Rs. 3,00,000** |
| **Operating losses before commercial production** | **Rs. 4,00,000** |

**Please advise Wivi Tsu Ltd. on the costs that can be capitalised in accordance with AS 10 (Revised). *(MTP Aug. '18, 5 Marks) (Same concept lesser adjustments MTP 5 Marks Nov'21, MTP 5 Marks Mar'23, SM, RTP May'19, Nov'18 & Nov '23)***

**Answer 10**

**According to AS 10 (Revised), the following costs can be capitalized:**

| | |
|---|---|
| Cost of the plant | Rs. 25,00,000 |
| Initial delivery and handling costs | Rs. 2,00,000 |
| Cost of site preparation | Rs. 6,00,000 |
| Consultants' fees | Rs. 7,00,000 |
| Estimated dismantling costs to be incurred after 7 years | **Rs. 3,00,000** |
| | **Rs. 43,00,000** |

**Note**: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of Rs.2,00,000 and operating losses before commercial production amounting to Rs.4,00,000 are not regarded as directly attributable costs and thus cannot be capitalized. They should be written off to the Statement of Profit and Loss in the period they are incurred.

## Question 11

**Star Limited purchased machinery for ₹ 6,80,000 (inclusive of GST of ₹ 40,000). Input credit is available for entire amount of GST paid. The company incurred the following other expense for installation.**

| | ₹ |
|---|---|
| **Cost of preparation of site for installation** | **21,200** |
| **Total Labour charges** | **56,000** |

**(200 out of the total of 500 men hours worked, were spent on installation of the machinery)**

| | |
|---|---|
| **Spare parts and tools consumed in installation** | **5,000** |
| **Total salary of supervisor** | **26,000** |
| **(Time spent for installation was 25% of the total time worked)**<br>**Total technical expense** | **34,000** |
| **(1/10 relates to the plant installation)**<br>**Test run and experimental production expenses** | **18,000** |
| **Consultancy charges to architect for plant set up** | **11,000** |
| **Depreciation on assets used for installation** | **12,000** |



**The machine was ready for use on 15.01.2021 but was used from 01.02.2021. Due to this delay further expenses of ₹ 8,900 were incurred. Calculate the value at which the plant should be capitalized in the books of Star Limited. *(RTP May 23, SM)***

**Answer 11**

**Calculation of Cost of Plant**

| **Particulars** | | ₹ |
|---|---|---|
| Purchase Price | Given | 6,80,000 |
| Add: Site Preparation Cost | Given | 21,200 |
| Labor charges | (56,000×200/500) Given | 22,400 |
| Spare parts | | 5,000 |
| Supervisor's Salary | 25% of ₹ 26,000 | 6,500 |
| Technical costs | 1/10 of ₹ 34,000 | 3,400 |
| Test run and experimental production charges | Given | 18,000 |
| Architect Fees for set up | Given | 11,000 |
| Depreciation on assets used for installation | Given | 12,000 |
| Total Cost of Asset | | 7,79,500 |
| Less: GST credit receivable | | (40,000) |
| Value to be capitalized | | 7,39,500 |

**Note:** Further Expenses of ₹ 8,900 from 15.1.2021 to 1.2.2021 to be charged to profit and loss A/c as plant was ready for production on 15.1.2021.

Question 12

**MS Ltd. has acquired a heavy machinery at a cost of ₹ 1,00,00,000 (with no breakdown of the component parts). The estimated useful life is 10 years. At the end of the sixth year, one of the major components, the turbine requires replacement, as further maintenance is uneconomical. The remainder of the machine is perfect and is expected to last for the next four years. The cost of a new turbine is ₹ 45,00,000. The discount rate assumed is 5%.**

**Can the cost of the new turbine be recognised as an asset, and, if so, what treatment should be used? *(RTP Jan'25)***

**Answer 12**

The new turbine will produce economic benefits to MS Ltd., and the cost is measurable. Hence, the item should be recognised as an asset. The original invoice for the machine did not specify the cost of the turbine; however, the cost of the replacement ₹ 45,00,000 can be used as an indication (usually by discounting) of the likely cost, six years previously.

**Statement showing cost of new turbine and machine after 6th year**

| | | | ₹ |
|---|---|---|---|
| Cost of machines recognized on purchase | | | 1,00,00,000 |
| *Less*: Depreciation charged for 6 years | [(1,00,00,000/ 10) x 6] | | (60,00,000) |
| | | | 40,00,000 |
| *Less*: Current cost of turbine to be derecognized: | | | |
| Cost of Turbine before 6 years | [45,00,000 x {1 / $(1.05)^6$}] | 33,57,900 | |
| *Less*: Depreciation for 6 years | [(33,57,900 / 10) x 6] | (20,14,740) | (13,43,160) |
| *Add*: Cost of new turbine to be recognised | | | 45,00,000 |
| Revised carrying amount of machine | | | 71,56,840 |

Question 13

**A Ltd. had following assets. Calculate depreciation for the year ended 31st March, 2020 for each asset as per AS 10 (Revised):**

**(i) Machinery purchased for ₹ 10 lakhs on 1st April, 2015 and residual value after useful life of 5 years, based on 2015 prices is ₹ 10 lakhs.**

**(ii) Land for ₹ 50 lakhs.**

**(iii) A Machinery is constructed for ₹ 5,00,000 for its own use (useful life is 10 years). Construction is completed on 1st April, 2019, but the company does not begin using the machine until 31st March, 2020.**

**(iv) Machinery purchased on 1st April.2017 for ₹ 50,000 with useful life of 5 years and residual value is NIL. On 1st April, 2019, management decided to use this asset for further 2 years only. *(PYP 5 Marks Nov 20) (MTP 5 Marks Sep '23)***

**Answer 13**

**Computation of amount of depreciation as per AS 10**

| | | ₹ |
|---|---|---|
| (i) | Machinery purchased on 1/4/15 for ₹ 10 lakhs (having residual value of ₹ 10 lakhs)<br>Reason: The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost. Therefore, there is no depreciable amount and depreciation is correctly zero. | Nil |
| (ii) | Land (50 lakhs) (considered freehold)<br>Reason: Land has an unlimited useful life and therefore, it is not depreciated. | Nil |
| (iii) | Machinery constructed for own use (₹ 5,00,000/10)<br>Reason: The entity should begin charging depreciation from the date the machine is ready for use i.e. 1st April,2019. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation. | 50,000 |
| (iv) | Machinery having revised useful life<br>Reason: The entity has charged depreciation using the straight-line method at ₹ 10,000 per | 15,000 |

| | |
|---|---|
| | annum i.e. (50,000/5 years). On 1st April,2019 the asset's net book value is [50,000 – (10,000 × 2)] i.e. ₹ 30,000. The remaining useful life is 2 years as per revised estimate. The company should amend the annual provision for depreciation to charge the unamortized cost over the revised remaining life of 2 years. Consequently, it should charge depreciation for the next 2 years at ₹ 15,000 per annum i.e. (30,000 / 2 years). |

## Question 15

**XYZ Limited provided you the following information for the year ended 31 st March, 2022.**

**(i) The carrying amount of a property at the end of the year amounted to ₹ 2,16,000 (cost/value ₹ 2,50,000 and accumulated depreciation ₹ 34,000). On this date the property was revalued and was deemed to have a fair value of ₹ 1,90,000. The balance in the revaluation surplus relating to a previous revaluation gain for this property was ₹ 20,000.**
**You are required to calculate the revaluation loss as per AS 10 (Revised) and give its treatment in the books of accounts.**

**(ii) An asset that originally cost ₹ 76,000 and had accumulated depreciation of ₹ 62,000 was disposed of during the year for ₹ 4,000 cash.**
**You are required to explain how the disposal should be accounted for in the financial statements as per AS 10 (Revised).** ***(PYP 5 Marks May '22)***

**Answer 15**

(i) As per AS 10, a decrease in the carrying amount of an asset arising on revaluation should be charged to the statement of profit and loss. However, the 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.

**Calculation of revaluation loss and its accounting treatment**

| | | ₹ |
|---|---|---|
| Carrying value of the asset as on 31st March, 2022 | a | 2,16,000 |
| Revalued amount of the asset | b | (1,90,000) |
| Total revaluation loss on asset | c=a-b | 26,000 |
| Adjustment of previous revaluation reserve | d | (20,000) |
| Net revaluation loss to be charged to the Profit and loss account | e=c-d | 6,000 |

(ii) AS 10 states that the carrying amount of an item of property, plant and equipment is derecognized on disposal of the asset. It further states that the gain or loss arising from the derecognition of an item of property, plant and equipment should be included in the statement of profit and loss when the item is derecognized. Gains should also not be classified as revenue.

Calculation of loss on disposal of the asset and its accounting treatment

| | | ₹ |
|---|---|---|
| Original cost of the asset | a | 76,000 |
| Accumulated depreciation till date | b | 62,000 |
| Carrying value of the asset as on 31st March, 2022 | c=a-b | 14,000 |
| Cash received on disposal of the asset | d | 4,000 |
| Loss on disposal of asset charged to the Profit and loss account | e=c-d | 10,000 |

## Question 16 LDR

**In the books of Top maker Limited, carrying amount of Plant and Machinery as on 1stApril, 2022 is ₹ 56,30,000. On scrutiny, it was found that a purchase of Machinery worth ₹ 21,12,000 was included in the purchase of goods on 1stJune, 2022. On 30thJune, 2022 the company disposed a Machine having book value of ₹ 9,60,000 (as on 1stApril, 2022) for ₹ 8,25,000 in part exchange of a new machine costing ₹ 15,65,000.**
**The company charges depreciation @ 10% p.a. on written down value method on Plant and Machinery.**
**You are required to compute:**

**(i) Depreciation to be charged to Profit & Loss Account;**
**(ii) Book value of Plant & Machinery as on 31stMarch, 2023; and**
**(iii) Profit/Loss on exchange of Plant & Machinery.** ***(PYP 5 Marks May '23)***

**Answer 16**

**(i) Depreciation to be charged in the Profit & Loss Account**

| Particulars | Amount in ₹ |
|---|---|
| Depreciation on old Machinery | 1,40,750 |
| [10% on ₹ 56,30,000 for 3 months (01.04.2022 to 30.06.2022)]<br>Add: Depreciation on Machinery acquired on 01.06.2022 | 1,76,000 |
| (₹21,12,000 X 10% X10/12)<br>Add: Depreciation on Machinery after adjustment of Exchange<br>[10% of ₹ 56,30,000 – 9,60,000 + 15,65,000) for 9 months] | 4,67,625 |
| **Total Depreciation to be charged in Profit & Loss A/c** | **7,84,375** |

**(ii) Book value of Plant & Machinery as on 31.3.2023**

| Particulars | | Amount in ₹ |
|---|---|---|
| Balance as per books on 01.04.2022 | | 56,30,000 |
| Add: Included in purchases on 01.06.2022 | 21,12,000 | |
| Add: Purchases on 30.06.2022 | **15,65,000** | **36,77,000**<br>93,07,000 |
| Less: Book value of Machine sold on 30.06.2022 | | (9,60,000)<br>83,47,000 |
| Less: Depreciation on Machinery in use<br>₹ (7,84,375 -24,000) | | (7,60,375) |
| Book Value as on 31.03.2023 | | 75,86,625 |

**Note**: The computation of depreciation and book value of Plant & Machinery can be presented in the following alternative manner:

| Particulars | Book Value or Cost or Acquisition | Period | Depreciation | Book Value as on 31.03.2023 |
|---|---|---|---|---|
| Opening Value | 46,70,000<br>(56,30,000 – 9,60,000) | 01.04.2022<br>to 31.03.2023 | 4,67,000<br>(46,70,000 x 10%) | 42,03,000 |
| Sold | 9,60,000 | 01.04.2022<br>to 30.06.2022 | 24,000<br>(9,60,000 x 10% x 3/12) | - |
| Purchases | 21,12,000 | 01.06.2022<br>to 31.03.2023 | 1,76,000<br>(21,12,000 x 10% x 10/12) | 19,36,000 |
| New Machinery | 15,65,000 | 01.07.2022<br>to 31.03.2023 | 1,17,375<br>(15,65,000 x 10% x 9/12) | 14,47,625 |
| Total | | | 7,84,375 | 75,86,625 |

**(iii) Profit/Loss on Exchange of Machinery**

| Particulars | Amount in |
|---|---|
| Balance as per books on 01.04.2022 | 9,60,000 |
| Less: Depreciation for 3 months (₹ 9,60,000 x 10 /100 x 3 / 12) | (**24,000**) |
| W.D.V. as on 30.06.2022 | 9,36,000 |
| Less: Exchange value | (8,25,000) |
| Loss on Exchange of Machinery | 1,11,000 |

**Question 17** LDR

**Akshar Ltd. installed a new Plant (not a qualifying asset), at its production facility, and incurred the following costs:**

- **Cost of the Plant (as per supplier's invoice): ₹ 30,00,000**

- **Initial delivery and handling costs: ₹ 1,00,000**
- **Cost of site preparation: ₹ 2,00,000**
- **Consultant fee for advice on acquisition of Plant: ₹ 50,000**
- **Interest charges paid to supplier against deferred credit: ₹ 1,00,000**
- **Estimate of Dismantling and Site Restoration costs: ₹ 50,000 after 10 years (Present Value is ₹ 30,000)**
- **Operating losses before commercial production: ₹ 40,000**

**The company identified motors installed in the Plant as a separate component and a cost of ₹ 5,00,000 (Purchase Price) and other costs were allocated to them proportionately. The company estimates the useful life of the Plant and those of the Motors as 10 years and 6 years respectively and SLM method of Depreciation is used.**

**At the end of Year 4, the company replaces the Motors installed in the Plant at a cost of ₹ 6,00,000 and estimated the useful life of new motors to be 5 years. Also, the company revalued its entire class of Fixed Assets at the end of Year 4. The revalued amount of Plant as a whole is ₹ 25,00,000. At the end of Year 8, the company decides to retire the Plant from active use and also disposed the Plant as a whole for ₹ 6,00,000. There is no change in the Dismantling and Site Restoration liability during the period of use. You are required to explain how the above transaction would be accounted in accordance with AS 10.** ***(SM)***

**Answer 17**

1. **Cost at Initial Recognition:**

| Particulars | ₹ |
|---|---|
| Cost of the Plant (as per Invoice) | 30,00,000 |
| Initial Delivery and Handling Costs | 1,00,000 |
| Cost of Site Preparation | 2,00,000 |
| Consultants' Fees | 50,000 |
| Estimated Dismantling and Site Restoration Costs | 30,000 |
| Total Cost of Plant including Motors | 33,80,000 |
| Less: Cost of Motors identified as a separate component (1/6)* | 5,63,333 |
| **Cost of the Plant (excluding Motors – balance 5/6)** | **28,16,667** |

* Purchase price of Motors = ₹ 5,00,000 out of ₹ 30,00,000 i.e., 1/6 of value of Plant

**Note:**

Since the asset is not a qualifying asset, payment of interest to the supplier is not capitalized. Further, operating losses of ₹40,000 incurred before commercial production is not a directly attributable cost, and hence excluded from cost of asset. These costs are expensed to the P/L as and when they are incurred.

2. **Recognition of Motors Replacement**

| Particulars | ₹ |
|---|---|
| Cost of Motors determined above | 5,63,333 |
| Less: Depreciation for 4 years (as per SLM) | 3,75,555 |
| 5,63,333 ÷ 6 years x 4 years | |
| **Carrying Amount of Motors at the end of Year 4** | **1,87,778** |

**Accounting:**

The company should derecognize the existing Carrying Amount of Motors replaced of ₹ 1,87,778. Further, the acquisition cost of new motors of ₹ 6,00,000 would be capitalized as a separate component. This amount will be depreciated over the next 5 years at ₹ 6,00,000 ÷ 5 years = ₹ 1,20,000 p.a.

3. **Revaluation**

| Particulars | ₹ |
|---|---|
| Cost of the Plant at initial recognition [from (1) above] | 28,16,667 |
| Less: SLM Depreciation for 4 years: ₹ 28,16,667 ÷ 10 years x 4 years | 11,26,667 |
| Carrying Amount of Plant at the end of Year 4 | 16,90,000 |
| Revalued Amount of Plant (Excluding Motors, since the same is treated as a separate component: ₹ 25,00,000 – ₹ 6,00,000) | 19,00,000 |
| Therefore, Gain on Revaluation credited to Revaluation Reserve | 2,10,000 |
| Revised Depreciation Charge p.a.: 19,00,000 ÷ 6 years | 3,16,667 |

4. **Derecognition**

| Particulars | Motors | Plant (excluding Motors) |
|---|---|---|
| Cost / Revalued Amount at end of Year 4 | 6,00,000 | 19,00,000 |
| Less: Depreciation for Years 5-8 | 1,20,000 x 4<br>= 4,80,000 | 3,16,667 x 4<br>=12,66,668 |
| Carrying Amount before Disposal / De- recognition | 1,20,000 | 6,33,332 |
| Less: Disposal Proceeds ₹ 6,00,000 allocated in ratio of carrying amount | 95,575 | 5,04,425 |
| Loss to be written off to P/L | 24,425 | 1,28,907 |

**Notes:**

(a) The Revaluation Surplus of ₹ 2,10,000 would be transferred directly to Retained Earnings.

(b) The allocation of disposal proceeds of ₹ 6,00,000 for the plant as whole is apportioned based on carrying amount of motors and plant (excluding motors)

Alternatively, it may be apportioned as 1/6 towards motors and 5/6 plant (excluding motors) based on the reasoning that the initially, motors amounted to 1/6 of the entire plant. This approach may not be preferable because there has been a revaluation of the plant (excluding motors) and a disposal and subsequent acquisition of the Motor, which is not in the initial proportion of 5/6 and 1/6 respectively.

**Multiple Choice Questions (MCQs)**

**1. As per AS 10 (Revised) 'Property, plant and equipment', which of the following costs is not included in the carrying amount of an item of PPE *(SM)***

(a) Costs of site preparation

(b) Costs of relocating

(c) Installation and assembly costs.

(d) initial delivery and handling costs

**Ans: (b)**

**2. As per AS 10 (Revised) 'Property, Plant and Equipment', an enterprise holding investment properties should value Investment property. *(SM)***

(a) as per fair value

(b) under discounted cash flow model.

(c) under cost model

(d) under cash flow model

**Ans: (c)**

**3. A plot of land with carrying amount of ₹ 1,00,000 was revalued to ₹ 1,50,000 at the end of Year 2. Subsequently, due to drop in market values, the land was determined to have a fair value of ₹ 1,30,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation? *(SM)***

(a) Initial upward valuation of ₹ 50,000 credited to Revaluation Reserve. Subsequent downward revaluation of ₹ 20,000 debited to P/L.

(b) Initial upward valuation of ₹ 50,000 credited to P/L. Subsequent downward revaluation of ₹ 20,000 debited to P/L.

(c) Initial upward valuation of ₹ 50,000 credited to Revaluation Reserve. Subsequent downward revaluation of ₹ 20,000 debited to Revaluation Reserve.

(d) Initial upward valuation of ₹ 50,000 debited to P/L. Subsequent downward revaluation of ₹ 20,000 credited to P/L.

**Ans: (c)**

**4. A plot of land with carrying amount of ₹ 1,00,000 was revalued to ₹ 90,000 at the end of Year 2. Subsequently, due to increase in market values, the land was determined to have a fair value of ₹ 1,05,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation? *(SM)***

(a) Initial downward valuation of ₹ 10,000 debited to Revaluation Reserve. Subsequent upward revaluation of ₹ 15,000 credited to P/L.

(b) Initial downward valuation of ₹ 10,000 debited to P/L. Subsequent upward revaluation of ₹ 15,000 credited to P/L.

(c) Initial downward valuation of ₹ 10,000 debited to P/L. Subsequent upward revaluation of ₹ 10,000 credited to P/L and ₹ 5,000 credited to Revaluation Reserve.

(d) Initial downward valuation of ₹ 10,000 credited to P/L. Subsequent upward revaluation of ₹ 10,000 debited to P/L and ₹ 5,000 debited to Revaluation Reserve.

**Ans: (c)**

5. **On sale of an asset which was revalued upwards, what would be the treatment of Revaluation Reserve? *(SM)***

(a) The Revaluation Reserve is credited to P/L since the profit on sale of such asset is now realized.

(b) The Revaluation Reserve is credited to Retained Earnings as a movement in reserves without impacting the P/L.

(c) No change in Revaluation Reserve since profit on sale of such asset is already impacting the P/L.

(d) The Revaluation Reserve is reduced from the asset value to compute profit or loss.

**Ans: (b)**

6. **A machinery was purchased having an invoice price ₹ 1,18,000 (including GST ₹ 18,000) on 1 April 20X1. The GST amount is available as input tax credit. The rate of depreciation is 10% on SLM basis. The depreciation for 20X2 -X3 would be *(SM)***

(a) ₹ 10,000.

(b) ₹ 11,800.

(c) ₹ 9,000.

(d) ₹ 10500

**Ans: (a)**

7. **Accounting Standard 10, Property, Plant and Equipment is applicable to: *(MTP 2 Marks Nov'24)***

(a) Biological Assets (other than Bearer Plants) related to agricultural activity

(b) Wasting Assets including Mineral rights, Expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non regenerative resources

(c) Inventories

(d) Bearer Plant (except produce on Bearer Plants)

**Ans: (d)**

A

# CHAPTER 5.3: AS–13 ACCOUNTING FOR INVESTMENTS

**CONCEPTS OF THIS CHAPTER**

- Forms of Investments
- Cost of Investments
- Current Investments
- Long-term Investments
- Classification of Investments
- Investment Properties
- Disposal of Investments
- Reclassification of Investments
- Disclosure Requirements

**LDR Questions**
Q 20 Q 29
Q 32

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Accounting for

➢ **Right shares**

- Subscribed Cost of shares added to carrying amount
- Not subscribed, but sold Sale proceeds taken to P&L A/c
- If acquired on cum-right basis & the market value of investments immediately after is lower than the right is lower than the cost for which they were acquired, apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

➢ **Bonus** • No amount is entered in the capital column of investment account



### Carrying Amount

➢ **Current investments**

**Lower of cost and fair value.**
- Any reduction to fair value is debited to profit and loss account, however, if fair value of investment is increased subsequently, the increase in value of current investment up to the cost of investment is credited to the profit and loss account (and excess portion, if any, is ignored).

**Valuation**
- On overall (or global) basis is not considered appropriate; prudent method is to carry investment individually.

➢ **Long term investments**

**Carried at cost**
- Where there is a decline, other than temporary, in the carrying amounts of long term valued investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

**Valuation** • Determined on an individual investment basis.

### Reclassification of Investments

- Current to Long-term
- Transfer at Lower of cost & fair value at the date of transfer
- Long-term to Current
- Transfer at lower of cost & carrying amount at the date of transfer

### Disposal of Investments

- Difference between the carrying amount and the disposal proceeds, net Of Expenses is recognised in the P & L statement.
- When part of investment is disposed, carrying amount is allocated to that part on the basis of average carrying amount of total investment.
- If investments held as stock-in-trade, cost of stocks disposed calculated as per cost formula as per AS 2.

### Disclosures

- Investment Valuation Policies: Accounting policies for investment valuation.

- Profit & Loss Inclusions:
  - Interest, dividends (separately for subsidiaries), and rental income, distinguishing between long-term and current investments.
  - Gross income stated, with tax deducted at source shown under advance taxes paid.
  - Profits/losses on disposal and changes in carrying amounts of current and long-term investments.
- Restrictions: Significant restrictions on ownership, realizability, or remittance of income and disposal proceeds.
- Investment Details: Aggregate amounts of quoted and unquoted investments, with market value of quoted investments.
- Other Disclosures: As required by relevant statutes

## Question & Answers

### Question 1

**Whether the accounting treatment 'at cost' under the head 'Long Term Investments' without providing for any diminution in value is correct and in accordance with the provisions of AS 13. If not, what should have been the accounting treatment in such a situation? What methodology should be adopted for ascertaining the provision for diminution in the value of investment, if any. Explain briefly. *(MTP 4 Marks Oct 20, Mar 22, SM)***

**Answer 1**

The accounting treatment 'at cost' under the head 'Long Term Investment' in the financial statements of the company without providing for any diminution in value is correct and is in accordance with the provisions of AS 13 provided that there is no decline, other than temporary, in the value of investment. If the decline in the value of investment is, other than temporary, compared to the time when the shares were purchased, provision is required to be made. The reduction in market value should not be considered, in isolation to determine the decline, other than temporary.

The amount of the provision for diminution in the value of investment may be ascertained considering the factors indicated in AS 13.



### Question 2

**How will you deal with the following in the financial statements of the Parish Electronics Ltd. as on 31.3.18 with reference to AS-13?**

**Also Parish Electronics Ltd. has current investment (X Ltd.'s shares) purchased for Rs. 5 lakhs, which the company want to reclassify as long term investment. The market value of these investments as on date of Balance Sheet was Rs. 2.5 lakhs. *(MTP Aug '18, 5 Marks, RTP May 19, MTP 5 Marks Oct '22)***

**Answer 2**

As per AS 13 'Accounting for Investments', where investments are reclassified from current to long -term, transfers are made at the lower of cost or fair value at the date of transfer.

In the given case, the market value of the investment (X Ltd. shares) is Rs.2.50 lakhs, which is lower than its cost i.e. Rs. 5 lakhs. Therefore, the transfer to long term investments should be made at cost of Rs. 2.50 lakhs. The loss of Rs. 2.50 lakhs should be charged to profit and loss account.

### Question 3

**Z Bank has classified its total investment on 31-3-2021 into three categories (a) held to maturity (b) available for sale (c) held for trading as per the RBI Guidelines. 'Held to maturity' investments are carried at acquisition cost less amortized amount. 'Available for sale' investments are carried at marked to market. 'Held for trading' investments are valued at weekly intervals at market rates. Net depreciation, if any, is charged to revenue and net appreciation, if any, is ignored. You are required to comment whether the policy of the bank is in accordance with AS 13? *(MTP 5 Marks Nov '21, RTP Nov 21, Nov 19)***

**Answer 3**

As per AS 13 'Accounting for Investments', the accounting standard is not applicable to Bank, Insurance Company, Mutual Funds. In this case Z Bank is a bank, therefore, AS 13 does not apply to it. For banks, the RBI has issued separate guidelines for classification and valuation of its investment and Z Bank should comply with those RBI Guidelines/Norms. Therefore, though Z Bank has not followed the provisions of AS 13, yet it would not be said as non-compliance since, it is complying with the norms stipulated by the RBI.

## Question 4

**JVR Limited has made investment of ₹ 97.84 Crores in Equity Shares of QSR Limited in 2016-17. The investment has been made at par. QSR Limited has been in continuous losses for the last 2 years. JVR Limited is willing to re-assess the carrying amount of its investment in QSR Limited and wish to provide for diminution in value of investment for the year ended 31st March, 2021. Discuss whether the connection of JVR Limited to bring down the carrying Amount of investment in QSR Limited is in accordance with Accounting Standards. *(RTP May '22)***

**Answer 4**

The investments are classified into two categories as per AS 13, viz., Current Investments and Long-term Investments. A current Investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made. The carrying amount for current investments is the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the statement of profit and loss. A long - term investment is an investment other than a current investment. The investments referred in the question can be classified as long-term investments and long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognize the decline. The contention of the company to bring down the value of investment may be correct if the decline in value is permanent in nature and the reduction in carrying amount may be charged to the statement of profit and loss. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

## Question 5

**(i) An unquoted long term investment made in the shares of Rachel Limited is carried in the books of Ziva Limited at a cost of ₹ 1,00,000. The audited financial statements of Rachel Limited received in May,2021 showed that the company had been incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 55,000.**

**(ii) On 1st December, 2021 Ziva Limited had made an investment of ₹ 5,00,000 in 4,000 Equity Shares of Garry Limited at a price of ₹ 125 per share with an intention to hold it for not more than six months. In the first week of March, 2022, Garry Limited suffered heavy loss due to an earthquake; the loss was not covered by an insurance policy. On 31st March,2022, the shares of Garry Ltd. were traded at a price of ₹ 80 per share on the Stock Exchange.**

**How would you deal with the above investments in the books of Ziva Limited for the year ended 31st March,2022 as per the provisions of Accounting Standard 13 'Accounting for Investments'? (PYP 5 Marks Nov '22)**

**Answer 5**

**(i)** Investments classified as long -term investments should be carried in the financial statements at cost. However, provision for diminution should be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

On this basis, the facts of the given case, it would be appropriate to reduce the carrying value of Long-term investments to ₹ 55,000 in the financial statements for the year ended 31st March, 2022.Thus the unquoted investment in the shares of Rachel Ltd. will be valued at ₹ 55,000

The provision for diminution amounting ₹ 45,000 should be made to reduce the carrying amount of the investments.

**(ii)** Equity Shares in Garry Ltd. will be considered as current investment as intended to hold for not more than six months. As per AS 13, "Accounting for Investments", carrying amount for current investments is the lower of cost and fair value. In respect of current Investments for which as active market exists, market value generally provides the best evidence of fair value.

Since on 31st March,2022, the shares of Garry Limited were trading at a price of ₹ 80 per share on the stock exchange, the equity shares of Garry Ltd. should be carried in the financial statements at realizable value i.e. at ₹ 3,20,000 (4,000 shares @ ₹ 80 per share).The reduction of ₹ 1,80,000 in carrying value of current investment will be charged to the statement of profit and loss for the year ended 31 st

March,2022.

## Question 6

**A company is engaged in the business of refining, transportation and marketing of petroleum products. During the financial year ended 31st March, 2024, the company acquired controlling interest from Government of India in another public sector undertaking @ ₹ 1,551 per share as against the book value of ₹ 192.58 per share and market value of ₹ 876 per share as on 18th February, 2024.**

**Thus, the strategic premium of ₹ 675 per share has been paid considering various tangible and intangible factors.**

**The above investment in the shares of the acquired company has been considered as long term strategic investment and, therefore, has been accounted for at cost, i.e. at ₹ 1,551 per share in the financial statements. No provision for diminution in value has been made in the books of account.**

**As per the requirement of Schedule III to the Companies Act, 2013, the aggregate market value of the quoted shares has been properly reflected in the financial statements.**

**On 28th March, 2024, the acquired shares were quoted at ₹ 880 per share on BSE and the current market price as on 18th July was around ₹ 300.**

**Considering the tangible and intangible benefits the Management is of the view that there is no permanent diminution in the value of the strategic investment in the acquired company, as the same has been considered as a long-term investment. Therefore, there is no need for provision for diminution in the value of the shares of the acquired company.**

**Required:**

**(i) Whether the accounting treatment 'at cost' under the head 'Long Term Investments' without providing for any diminution in value is correct and in accordance with the provisions of AS 13.**

**(ii) If any provision for diminution in the value is to be made, whether such provision should be charged to the profit and loss account or whether same can be considered as deferred expenditure and amortised over a period of 5 years. Whether it is open for the company to charge off such diminution in the value in the books of account instead of creating provision.**

**(iii) Whether the premium paid for strategic benefits for investment described in facts of the case, can be accounted for separately in the books of account keeping in view that AS 13 specifies that long term investments should be recorded at cost and there is no specific provision in the standard in respect of accounting for premium paid for strategic benefits.** ***(RTP Sep'24, SM)***

**Answer 6**

**(i)** The accounting treatment 'at cost' under the head 'Long Term Investment' in the separate financial statements of the company without providing for any diminution in value is correct and is in accordance with the provisions of AS 13 provided that there is no decline, other than temporary, in the value of investment.

**(ii)** The provision for diminution in the value of investment should be a charge to the profit and loss statement. As per the requirements of AS 13, the diminution in the value of investment can neither be accounted for as deferred revenue expenditure nor it can be written off in the statement of profit and loss.

**(iii)** The long-term investments should be carried at cost as per the requirements of AS 13. The amount paid over and above the market price should be treated as cost and cannot be accounted for separately.

## Question 7

**Paridhi Electronics Ltd. invested in the shares of Dhansukh Ltd. on 1st May 2020 at a cost of Rs. 10,00,000. Three fourth of these investments were current investments and the remaining investments were intended to be held for more than a year. The published accounts of Dhansukh Ltd. received in January, 2021 reveals that the company has incurred cash losses with decline in market share and investment of Paridhi Electronics Ltd. may not fetch more than 7,50,000. The reduction in value is apparent to be non-temporary. You are required to explain how you will deal with the above in the financial statements of the Paridhi Electronics Ltd. as on 31.3.21 with reference to AS 13?** ***(RTP May '21,) (Same concepts different figures RTP May 18, MTP 4 Marks, Oct'21)***

**Answer 7**

As per AS 13, "Accounting for Investments", carrying amount for current investments is the lower of cost and fair value. But long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognize a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. The standard also states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. Paridhi Ltd. made three fourth of Rs. 10,00,000 ie. Rs.7,50,000 as current investment and remaining Rs. 2,50,000 as long term. The facts of the case given in the question clearly suggest that the provision for diminution should be made to reduce the carrying amount of shares for both categories of shares to bring them to market value. Hence the carrying value of investments will be shown at amount of Rs. 7,50,000 in the financial statements for the year ended 31st March, 2021 and charge the difference of loss of Rs. 2,50,000 to profit and loss account.

## Question 8

**Innovative Garments Manufacturing Company Limited invested in the shares of another company on 1st October, 2022 at a cost of ₹ 2,50,000. It also earlier purchased Gold of ₹ 4,00,000 and Silver of ₹ 2,00,000 on 1st March, 2020. Market value as on 31st March, 2023 of above investments are as follows:**

| | |
|---|---|
| Shares | 2,25,000 |
| Gold | 6,00,000 |
| Silver | 3,50,000 |

**How above investments will be shown in the books of accounts of Innovative Garments Manufacturing Company Limited for the year ending 31st March, 2023 as per the provisions of Accounting Standard 13 "Accounting for Investments"? *(MTP 5 Marks Mar'24) (Same concept different figures RTP Nov'18,May 23, SM)***

**Answer 8**

As per AS 13 (Revised) 'Accounting for Investments', for investment in shares if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (₹ 2,50,000) and market value (₹ 2,25,000) as on 31 March 2023, i.e., ₹ 2,25,000.

If equity shares are acquired with an intention to hold for long term period (more than one year), then should be considered as long-term investment to be shown at cost in the Balance Sheet of the company. However, provision for diminution should be made to recognise a decline, if other than temporary, in the value of the investments.

Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 1st March, 2020) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31st March, 2023, i.e., ₹ 4,00,000 and ₹ 2,00,000 respectively, though their market values have been increased.

## Question 9

**Gowtham Limited invested in shares of another company (with the intention to hold the shares for short-term period) on 30th November, 2021 at a cost of ₹ 4,25,000. It also earlier purchased Gold of ₹ 8,00,000 and Silver of ₹ 3,50,000 on 31st March 2019.**

**Market values as on 31st March, 2022, of the above investments are as follows:**

**Shares ₹ 3,50,000**

**Gold ₹ 10,25,000**

**Silver ₹ 5,10,000**

**You are required to explain how will the above investments be shown (individually and in total) in the books of account of Gowtham Limited for the year ending 31st March, 2022 as per the provisions of AS 13. *(RTP May 23, SM) (Same concept different figures RTP Nov'18)***

**Answer 9**

As per AS 13 (Revised) 'Accounting for Investments', for investment in shares - if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (₹ 4,25,000) and market value (₹ 3,50,000) as on 31 March 2022, i.e., ₹ 3,50,000.

Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 31stMarch, 2019) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31st March,

2022, i.e., ₹ 8,00,000 and ₹3,50,000 respectively, though their market values have been increased.
Thus the shares, gold and silver will be shown at ₹ 3,50,000, ₹ 8,00,000 and ₹ 3,50,000 respectively and hence, total investment will be valued at ₹ 15,00,000 for the year ending on 31st March, 2022 as per AS 13.

### Question 10

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

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

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

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

**(iv) Current investment in Company D, costing ₹ 18 lakhs is to be re-classified as long term investment. The market value on the date of reclassification is ₹ 16.5 lakhs.** ***(PYP 5 Marks Jan '21, Old & New SM) (MTP 5 Marks Sep '23)***

**Answer 10**

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

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

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

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

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

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

### Question 11

**On 15th June, 2024, Y limited wants to re-classify its investments in accordance with AS 13 (revised). Decide and state the amount of transfer, based on the following information:**

**(1) A portion of long term investments purchased on 1st March, 2023 are to be re-classified as current investments. The original cost of these investments was ₹ 14 lakhs but had been written down by ₹ 2 lakhs (to recognise 'other than temporary' decline in value). The market value of these investments on 15th June, 2024 was ₹ 11 lakhs.**

**(2) Another portion of long term investments purchased on 15th January, 2023 are to be re-classified as current investments. The original cost of these investments was ₹ 7 lakhs but had been written down to ₹ 5 lakhs (to recognize 'other than temporary' decline in value). The fair value of these investments on 15th June, 2024 was ₹ 4.5 lakhs.**

**(3) A portion of current investments purchased on 15th March, 2024 for ₹ 7 lakhs are to be re-classified as long term investments, as the company has decided to retain them. The market value of these investments on 31st March, 2024 was ₹ 6 lakhs and fair value on 15th June 2024 was ₹ 8.5 lakhs.**

**(4) Another portion of current investments purchased on 7th December, 2023 for ₹ 4 lakhs are to be re-classified as long term investments. The market value of these investments was:**

| | |
|---|---|
| on 31st March 2024 | ₹ 3.5 lakhs |
| on 15th June, 2024 | ₹3.8 lakhs |

***(MTP 7 Marks July'24, PYP May '19, 5 Marks, MTP 4 Marks Apr'24)***

**Answer 11**

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

(i) In this case, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at ₹ 12 lakhs in the books.

(ii) In this case also, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at ₹ 5 lakhs in the books.

(iii)In this case, reclassification of current investment into long-term investments will be made at ₹ 7 lakhs as cost is less than its fair value of ₹ 8.5 lakhs on the date of transfer.

(iv)In this case, market value (considered as fair vale) is ₹ 3.8 lakhs on the date of transfer which is lower than the cost of ₹ 4 lakhs. The reclassification of current investment into long-term investments will be made at ₹ 3.8 lakhs.

## Question 12

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

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

**You are required to:**

1. **Classify his investment in accordance with AS-13 (revised).**
2. **Value of Investment in mutual fund as on 31.03.2021*(PYP 5 Marks, Dec '21)***

**Answer 12**

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

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

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

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

## Question 13

**Mother Mart Ltd., wants to re-classify its investment in accordance with AS 13. Decide the treatment to be given in each of the following cases assuming that the market value has been determined in an arm's length transaction between knowledgeable and willing buyer and seller:**

(i) **A portion of current investments purchased for ₹ 25 lakhs to be reclassified as long-term investments, as the company has decided to retain them. The market value as on the date of balance sheet was ₹ 30 lakhs. The fair value of the investments on the date of transfer is same as the market value on the balance sheet date**

(ii) **Another portion of current investments purchased for ₹ 20 lakhs has to be re- classified as long-term investments. The Fair value of these investments as on the date of the balance sheet was ₹ 12.5 lakhs.**

(iii) **One portion of long-term investments, no longer considered for holding purposes, to be reclassified as current investments. The original cost of these was ₹ 15 lakhs, but had been written down to ₹ 11 lakhs to recognize permanent decline as per AS 13. *(RTP Nov'22, SM)***

**Answer 13**

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

(i) In the first case, the market value of the investments is ₹ 30 lakhs, which is higher than its cost i.e. ₹ 25 lakhs. Therefore, the transfer to long term investments should be made at cost i.e. ₹ 25 lakhs

(ii) In the second case, the market value of the investment is ₹ 12.5 lakhs, which is lower than its cost i.e. ₹ 20 lakhs. Therefore, the transfer to long term investments should be made in the books at the market value i.e. ₹ 12.5 lakhs. The loss of ₹ 7.50 lakhs (20-12.5) should be charged to Profit and Loss statement.

(iii) In the third case, the book value of the investments is ₹ 11 lakhs, which is lower than its cost, i.e. ₹ 15 lakhs. As the transfer should be at carrying amount, hence this re-classified current investment should be carried at ₹ 11 lakhs.

## Question 14

**Omega Limited (listed company) issued ₹ 4,50,000 5% Debentures on 30th September 2020 on which interest is payable half yearly on 31st March and 30th September. The company has power to purchase debentures in the open market for cancellation thereof. On 31 December 2020, investments made for the purpose of redemption were ₹ 67,500. The following purchases were made during the year ended 31st December, 2022 and the cancellation were made on the same date 1st March 2022 - ₹ 75,000 nominal value purchased for ₹ 74,175 ex-interest.**

**1st September 2022 - ₹ 60,000 nominal value purchased for ₹ 60,375 cum-interest. You are required to draw up the following accounts up to the date of cancellation:**

**(i) Debentures Account; and**

**(ii) Own Debenture (Investment) Account. Ignore taxation.** ***(MTP 5 Marks March '23)***

**Answer 14**

**Omega Limited Debenture Accounts**

| 2022 | | ₹ | 2022 | | ₹ |
|---|---|---|---|---|---|
| Mar 1 | To Own Debentures | 74,175 | Jan 1 | By Balance b/d | 4,50,000 |
| Mar 1 | To Profit on cancellation (25,000-24,725) | 825 | | | |
| Sep 1 | To Own Debentures (Note 3) | 59,124 | | | |
| Sep 1 | To Profit on cancellation (20,000-19,708) | 876 | | | |
| Dec 31 | Balance c/d | 3,15,000 | | | |
| | | 4,50,000 | | | 4,50,000 |

**Own Debenture (Investment) Account**

| | | Nominal Cost ₹ | Interest ₹ | Cost ₹ | | | Nominal Cost ₹ | Interest ₹ | Cost ₹ |
|---|---|---|---|---|---|---|---|---|---|
| 2022 | | | | | 2022 | | | | |
| Mar 1 | To Bank (W.N. 1) | 75000 | 1563 | 74,175 | Mar 1 | By Debentures A/c | 75,000 | - | 74,175 |
| Sep 1 | To Bank (W.N. 2 & 3) | 60,000 | 1,251 | 59,124 | Sep 1 | By Debentures A/c | 60,000 | - | 59,124 |
| | | | | - | Dec. 31 | By P&L A/c | - | 2,814 | - |
| | | 1,35,000 | 2,814 | 1,33,299 | | | 1,35,000 | 2,814 | 1,33,299 |

**Working notes:**

1. 75,000 x 5% x 5/12 = 1,563
2. 60,000 x 5% x 5/12 = 1,251
3. 60,375 – 1,251= 59,124

## Question 15

**On 1st April, 2019 Mr. Shyam had an opening balance of 1000 equity shares of X Ltd Rs. 1,20,000 (face**

value Rs.100 each). On 5.04.2019 he further purchased 200 cum-right shares for Rs. 135 each. On 8.04.2019 the director of X Ltd announced right issue in the ratio of 1:6.

Mr. Shyam waived off 100% of his entitlement of right issue in the favour of Mr. Rahul at the rate of Rs. 20 each. All the shares held by Shyam had been acquired on cum right basis and the total market price (ex-right) of all these shares after the declaration of rights got reduced by Rs. 3,400. On 10.10.2019 Shyam sold 350 shares for Rs. 140 each. 31.03.2020 The market price of each share is Rs. 125 each. You are required to prepare the Investment account in the books of Mr. Shyam for the year ended 31.03.2020 assuming that the shares are being valued at average cost. *(RTP May '21)*

**Answer 15**

**In the books of Mr. Shyam**

**for the year ending on 31-3-2020 (Scrip: Equity Shares of X Limited)**

| Date | Particulars | Qty | Amount | Date | Particulars | Qty | Amount |
|---|---|---|---|---|---|---|---|
| 1.4.2019 | To Balance b/d | 1000 | 1,20,000 | 8.04.2019 | By Bank A/c (W.N.1) | | 3,400 |
| 5.04.2019 | To Bank (200x Rs.135) | 200 | 27,000 | 10.10.2019 | By Bank A/c (350x Rs.140) | 350 | 49,000 |
| 10.10.2019 | To Profit & Loss A/c (W.N.2) | | 7,117 | 31.3.2020 | By Balance c/d (W.N.3) | 850 | 1,01,717 |
| | | 1200 | 1,54,117 | | | 1200 | 1,54,117 |

**Working Notes:**

1. **Sale of Rights Rs. 4,000**

   The market price of all shares of X Ltd after shares becoming ex-rights has been reduced by Rs. 3,400
   In this case out of sale proceeds of Rs.4,000; Rs. 3,400 may be applied to reduce the carrying amount to the market value and Rs. 600 would be credited to the profit and loss account.

2. **Profit on sale of 350 shares**

| | | | Amount |
|---|---|---|---|
| Sale price of 350 shares | (350 shares X 140 each) | Rs. | 49,000 |
| Less: Cost of 350 shares [(1,20,000+27,000-3,400) X350]/1200 | | Rs. | 41,883 |
| Profit | | Rs. | 7,117 |

3. **Valuation of 850 shares as on 31.03.2020**

| Particulars | Amount |
|---|---|
| Cost price of 850 shares [(1,20,000 +27,000 -3,400) x 850 /1,200] | Rs. 1,01,717 |
| Fair Value as on 31.03.2020 [850 X Rs. 125 each] | Rs. 1,06,250 |
| Cost price or fair value whichever is less | Rs. 1,01,717 |

## Question 16

On 1st April, 2022, Vivit Su has 1,00,000 equity shares of Beta Ltd. at a book value of ₹ 15 per share (nominal value ₹ 10 each). He provides you the further information:

1. On 20th June, 2022 he purchased another 20,000 shares of Beta Ltd. at ₹ 16 per share
2. On 1st August, 2022, Beta Ltd. issued one equity bonus share for every six shares held by the shareholders.
3. On 31st October, 2022, the directors of Beta Ltd. announced a right issue which entitles the holders to subscribe three shares for every seven shares at ₹ 15 per share. Shareholders can transfer their rights in full or in part.

Vivit Su sold 1/3rd of entitlement to Umang for a consideration of ₹ 2 per share and subscribed the rest on 5th November, 2022.

You are required to prepare Investment A/c in the books of Vivit Su for the year ending 31st March, 2023. *(RTP Nov '23, PYP 4 Marks Sep'24, MTP 6 Marks Sep 22, MTP 8 Marks March '21, SM)*

**Answer 16**

**In the books of Vivit Su**

**Investment Account (Equity shares in Beta Ltd.)**

| Date | Particulars | No. of shares | Amount (₹) | Date | Particulars | No. of shares | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 1.4.2022 | To Balance b/d | 1,00,000 | 15,00,000 | 31.3.2023 | By Balance c/d (By bal b/d) | 1,80,000 | 24,20,000 |
| 20.6.2022 | To Bank A/c | 20,000 | 3,20,000 | | | | |
| 1.8.2022 | To Bonus issue (W.N.1) | 20,000 | - | | | | |
| 5.11.2022 | To Bank A/c | | | | | | |
| | (right shares) (W.N.4) | 40,000 | 6,00,000 | | | | |
| | | 1,80,000 | 24,20,000 | | | 1,80,000 | 24,20,000 |

**Working Notes:**

(1) Bonus Shares = $\frac{1,00,000+20,000}{6}$ = 20,000 Shares

(2) Right Shares = $\frac{1,00,000+20,000+20,000}{7}$ X 3 = 60,000 Shares

(3) Sale of Rights = 60,000 Shares $\times \frac{1}{3} \times$ Rs. 2 = Rs. 40,000 to be credited to Statement of Profit & Loss

(4) Right subscribed = 60,000 Shares $\times \frac{2}{3} \times$ Rs. '15 = Rs. 6,00,000

## Question 17

**On 1st April 2021 Ms. Jayshree has 5,000 equity shares of Rama Limited (a listed company) of face value of₹ 10 each. Ms. Jayshree has purchased the above shares at ₹ 15 per share and paid a brokerage of 2% and stamp duty of 1 %.**

**On 15th May,2021 Ms. Jayshree purchased another 5,000 shares of Rama Limited at ₹ 18 including brokerage and stamp duty.**

**On 26th August,2021 Rama Limited issued one bonus equity share for every 1 equity share held by the shareholders.**

**On 23rd October,2021 Rama Limited announced a Right Issue which entitles the holders to subscribe 1 equity share for every 2 equity shares held at ₹ 20 per share. Shareholders can exercise their rights in full or in part. Ms. Jayshree sold 1/4th of entitlement to Mr. Mike for a consideration of ₹ 10 per share and subscribed the rest on 1st November 2021.**

**Ms. Jayshree also sold 10,000 shares at ₹ 25 per share on 1st November,2021. The shares of Rama Limited were quoted at ₹ 11 per share on 31st March,2022.**

**You are required to prepare Investment account for Ms. Jayshree for the year ended 31st March 2022.** ***(PYP, 5 Marks, May 22)***

**Answer 17**

**In the books of Ms. Jayshree**

**Investment Account (Equity shares in Rama Ltd.)**

| Date | Particulars | No. of shares | Amount (₹) | Date | Particulars | No. of shares | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 1.4.21<br>15.5.21 | To Balance b/d<br>To Bank A/c | 5,000<br>5,000 | 77,250<br>90,000 | 1.11.21 | By Bank A/c | 10,000 | 2,50,000 |
| 26.8.21 | To Bonus issue (W.N.1) | 10,000 | - | 31.3.22 | By Balance c/d | 17,500 | 1,92,500 |
| 1.11.21 | To Bank A/c (right shares) (W.N.4) | 7,500 | 1,50,000 | 31.3.22 | By Profit & Loss A/c (loss on valuation) | | 9,386 |
| 1.11.21 | To Profit & Loss A/c | | 1,34,636 | | | | |
| | | 27,500 | 4,51,886 | | | 27,500 | 4,51,886 |

**Working Notes:**

(1) Profit on sale of shares (average cost basis) on 1.11.21 10,000 shares @ ₹ 25 per share = 2,50,000

Cost of shares sold = [(77,250 + 90,000 + 1,50,000)/27,500 x 10,000]

= ₹ 1,15,364

Profit on sale of shares = ₹ 1,34,636

(2) Value of shares on 31.3.22 [77,250 + 90,000 + 1,50,000)/27,500 x 17,500]

= ₹ 2,01,886 or ₹ 1,92,500 (17,500 shares at ₹ 11)

Shares will be valued at ₹, 1,92,500 as market value is less than cost.

**Note: Average cost basis has been considered for valuation of shares at the year end and for calculation of cost of shares sold in the given answer.**

## Question 18

**Vivit Su Ltd. purchased 5,000, 13.5% Debentures of Face Value of ₹ 100 each of Pergot Ltd. on 1st May 2021 @ ₹ 105 on cum interest basis. The interest on these debentures is payable on 31st & 30th of March & September respectively. On August 1st 2021 the company again purchased 2,500 of such debentures @ ₹ 102.50 each on cum interest basis. On October 1st, 2021 the company sold 2,000 Debentures @ ₹ 103 each on ex- interest basis. The market value of the debentures as at the close of the year was ₹ 106. You are required to prepare the Investment in Debentures Account in the books of Vivit Su Ltd. for the year ended 31st Dec. 2021 on Average Cost Basis.** ***(RTP Nov'22, MTP 8 Marks , Nov '21)***

**Answer 18**

**Books of Vivit Su Ltd.**

**Investment in 13.5% Debentures in Pergot Ltd. Account (Interest payable on 31st March & 30th September)**

| Date | Particulars | Nominal | Interest | Amount | Date | Particulars | Nominal | Interest | Amount |
|---|---|---|---|---|---|---|---|---|---|
| 2021 | | ₹ | ₹ | ₹ | 2021 | | ₹ | ₹ | ₹ |
| May 1 | To Bank | 5,00,000 | 5,625 | 5,19,375 | Sept.30 | By Bank | | 50,625 | |
| | | | | | | (6 months Int) | | | |
| Aug.1 | To Bank | 2,50,000 | 11,250 | 2,45,000 | Oct.1 | By Bank | 2,00,000 | | 2,06,000 |
| Oct.1 | To P&L A/c | | | 2,167 | | | | | |
| Dec.31 | To P&L A/c | | 52,313 | | | | | | |
| | | | | | Dec.31 | By Balance c/d | 5,50,000 | 18,563 | 5,60,542 |
| | | 7,50,000 | 69,188 | 7,66,542 | | | 7,50,000 | 69,188 | 7,66,542 |

**Note:** Cost being lower than Market Value the debentures are carried forward at Cost.

**Working Notes:**

1. Interest paid on ₹ 5,00,000 purchased on May 1st, 2021 for the month of April 2021, as part of purchase price: 5,00,000 x 13.5% x 1/12 = ₹ 5,625
2. Interest received on 30th Sept. 2021
   On ₹ 5,00,000 = 5,00,000 x 13.5% x ½ = 33,750
   On ₹ 2,50,000 = 2,50,000 x 13.5% x ½ = 16,875
   Total ₹ 50,625
3. Interest paid on ₹ 2,50,000 purchased on Aug. 1st 2021 for April 2021 to July 2021 as part of purchase price:
   2,50,000 x 13.5% x 4/12 = ₹ 11,250
4. Loss on Sale of Debentures Cost of acquisition
   (₹ 5,19,375 + ₹ 2,45,000) x ₹ 2,00,000/₹ 7,50,000 = 2,03,833
   Less: Sale Price (2,000 x 103) = 2,06,000
   Profit on sale = ₹ 2,167
5. Cost of Balance Debentures
   (₹ 5,19,375 + ₹ 2,45,000) x ₹ 5,50,000/₹ 7,50,000 = ₹ 5,60,542
6. Interest on Closing Debentures for period Oct.-Dec. 2021 carried forward (accrued interest)
   ₹ 5,50,000 x 13.5% x 3/12 = ₹ 18,563

## Question 19

**On 1st April, 2019, Mr. Vijay had 30,000 Equity shares in X Ltd. (the company) at a book value of ₹ 4,50,000 (Face Value ₹ 10 per share). On 22nd June, 2019, he purchased another 5000 shares of the same company for ₹ 80,000. The Directors of X Ltd. announced a bonus of equity shares in the ratio of one share for seven shares held on 10th August, 2019.**

**On 31st August, 2019 the Company made a right issue in the ratio of three shares for every eight shares held, on payment of ₹ 15 per share. Due date for the payment was 30th September, 2019, Mr. Vijay**

subscribed to 2/3rd of the right shares and sold the remaining of his entitlement to Viru for a consideration of ₹ 2 per share.

On 31stOctober,2019, Vijay received dividends from X Ltd. @ 20% for the year ended 31 st March, 2019. Dividend for the shares acquired by him on 22ndJune,2019 to be adjusted against the cost of purchase.

On 15th November, 2019 Vijay sold 20,000 Equity shares at a premium of ₹ 5 per share.

You are required to prepare Investment Account in the books of Mr. Vijay for the year ended 31st March, 2020 assuming the shares are being valued at average cost. *(MTP 8 Marks,Oct'21 & MTP 10 Marks May'20,SM)*

**Answer 19**

**Books of Vijay Investment Account (Scrip: Equity Shares in X Ltd.)**

| | | No. | Amount | | | No. | Amount |
|---|---|---|---|---|---|---|---|
| | | | ₹ | | | | ₹ |
| 1.4.2019<br>22.6.2019 | To Bal b/d To<br>Bank | 30,000<br>5,000 | 4,50,000<br>80,000 | 31.10.2019 | By Bank<br>(dividend | - | 10,000 |
| 10.8.2019<br>30.9.2019 | To Bonus to<br>Bank<br>(Rights Shares) | 5,000<br>10,000 | -<br>1,50,000 | | On shares<br>acquired on<br>22/6/2019) | | |
| 15.11.2019 | To Profit<br>(on sale of shares) | | 32,000 | 15.11.2019 | By Bank<br>(Sale of shares) | 20,000 | 3,00,000 |
| | | | | 31.3.2020 | By Bal. c/d | 30,000 | 4,02,000 |
| | | 50,000 | 7,12,000 | | | 50,000 | 7,12,000 |

**Working Notes:**

(1) Bonus Shares30,000+50,000)/7=5,000 shares

(2) Rights shares= $\frac{(30,000+5,000+5,000)}{8} \times 3 = 15,000$ shares

(3) Rights shares sold = 15,000×1/3 = 5,000 shares

(4) Dividend received = 30,000×10×20% = ₹60,000 will be taken to P&L statement

(5) Dividend on shares purchased on 22.6.2019= 5,000×10×20% = ₹ 10,000 is adjusted to Investment A/c

(6) Profit on sale of 20,000 shares
= Sales proceeds – Average
Sales proceeds =Rs.3,00,000
Average cost =
= ₹ $\frac{(4,50,000+80,000+1,50,000-10,000)}{50,000} \times 20,000 = Rs. 2,68,000$
Profit = ₹ 3,00,000– ₹2,68,000= ₹32,000.

(7) Cost of shares on 31.3.2020
=₹ $\frac{(4,50,000+80,000+1,50,000-10,000)}{50,000} \times 30,000 = Rs. 4,02,000$

(8) Sale of rights amounting ₹ 10,000 (₹ 2 x 5,000 shares) will not be shown in investment A/c but will directly be taken to P & L statement.

## Question 20 — LDR

Mr. Wise had 12% Debentures of Face Value ₹ 100 of Vivit Su Ltd. as current investments. He provides the following details relating to the investments.

| | |
|---|---|
| 1-4-2020 | Opening balance 4,000 debentures costing ₹ 98 each |
| 1-6-2020 | Purchased 2,000 debentures @ ₹ 120 cum interest |
| 1-9-2020 | Sold 3,000 debentures @ ₹ 110 cum interest |
| 1-12-2020 | Sold 2,000 debentures @ ₹ 105 ex interest |
| 31-1-2021 | Purchased 3,000 debentures @ ₹ 100 ex interest |
| 31-3-2021 | Market value of the investments ₹ 105 each |

Interest due dates are 30th June and 31st December. Mr. Wise closes his books on 31-3-2021. He incurred 2% brokerage for all his transactions. Show investment account in the books of Mr. Wise assuming FIFO method is followed. *(RTP May '22)*

**Answer 20**

**Investment A/c of Mr. Wise**

**for the year ending on 31-3-2021 (Scrip: 12% Debentures of Vivit Su Limited)**
**(Interest Payable on 30th June and 31st December)** **Amount in ₹**

| Date | Particulars | Nominal Value | Interest | Cost | Date | Particulars | Nominal Value | Interest | Cost |
|---|---|---|---|---|---|---|---|---|---|
| 1.4.2020 | To Balance b/d | 4,00,000 | 12,000 | 3,92,000 | 30.6.2020 | By Bank (6,00,000 x 6%) | - | 36,000 | - |
| 1.6.2020 | To Bank | 2,00,000 | 10,000 | 2,34,800 | 1.9.2020 | By Bank | 3,00,000 | 6,000 | 3,17,400 |
| 1.9.2020 | To Profit & Loss A/c | | | 23,400 | 1.12.2020 | By Bank | 2,00,000 | 10,000 | 2,05,800 |
| 31.1.2021 | To Bank | 3,00,000 | 3,000 | 3,06,000 | 1.12.2020 | By Profit & Loss a/c | - | - | 9,600 |
| 31.3.2021 | To Profit & Loss A/c (Bal. fig.) | | 45,000 | | 31.12.20 | By Bank (1,00,000 x 6%) | - | 6,000 | - |
| | | | | | 31.3.2021 | By Profit & Loss A/c | - | - | 3,400 |
| | | | | | 31.3.2021 | By Balance c/d | 4,00,000 | 12,000 | 4,20,000 |
| | | 9,00,000 | 70,000 | 9,56,200 | | | 9,00,000 | 70,000 | 9,56,200 |

**Working Notes:**

1. **Valuation of closing balance as on 31.3.2021**

| | ₹ | |
|---|---|---|
| Market value of 4,000 Debentures at ₹ 105 | | 4,20,000 |
| Cost price of 1,000 debentures at | 1,17,400 | |
| 3,000 debentures at | 3,06,000 | 4,23,400 |
| Value at the end = ₹ 4,20,000 i.e., whichever is less | | |

2. **Profit on sale of debentures as on 1.9.2020**

| | ₹ |
|---|---|
| Sales price of debentures (3,000 x ₹ 110) | 3,30,000 |
| Less: Brokerage @ 2% | (6,600) |
| | 3,23,400 |
| Less: Interest for 2 months | (6,000) |
| Less: Cost price of Debentures $\left(3,92,000 \times \frac{3,000}{4,000}\right)$ | (2,94,000 |
| Profit on sale | 23,400 |

3. **Loss on sale of debentures as on 1.12.2020**

| | ₹ |
|---|---|
| Sales price of debentures (2,000 x ₹ 105) | 2,10,000 |
| Less: Brokerage @ 2% | (4,200) |
| | 2,05,800 |
| Less: Cost price of Debentures (98,000 + 1,17,400) | (2,15,400) |
| Loss on sale | 9,600 |

4. **Purchase Cost of 2,000 debentures on 1.6.2020**

| | ₹ |
|---|---|
| 2000 Debentures @₹ 120 cum interest | 2,40,000 |
| Add: Brokerage @ 2% | 4,800 |
| | 2,44,800 |
| Less: Interest for 5 months | (10,000) |
| Purchase cost of 2,000 debentures | 2,34,800 |

5. **Sale value for 3,000 debentures on 1.9.2020**

| | ₹ |
|---|---|
| Sales price of debentures cum interest (3,000 x ₹ 110) | 3,30,000 |

| | |
|---|---|
| Less: Brokerage @ 2% | (6,600) |
| | 3,23,400 |
| Less: Interest for 2 months | (6,000) |
| Sale value for 3,000 debentures | 3,17,400 |

## Question 21

**Remo Ltd. held on 1st April, 2021, 1000 9% Government Securities at ₹ 90,000 (Face Value of Security ₹ 100 each). Three month's interest had accrued on the above date. On 1 st May, the company purchased the same Government Securities of the face value of ₹ 80,000 at ₹ 95 cum-interest. On 1st June, ₹ 60,000 face value of the security was sold at ₹ 94 cum-interest. Interest on the security was paid each year on 30 th June and 31st December and was credited by the bank on the same date. On 30th September,**
**₹ 40,000 face value of the Govt. securities were sold at ₹ 97 cum-interest. On 1st December, the company purchased the same security ₹ 10,000 at par ex-interest. On 1st March, the company sold ₹ 10,000 face value of the government securities at ₹ 95 ex- interest.**
**You are required to draw up the 9% Government Security Account in the books of Remo Limited. FIFO method shall be followed.**
**Calculation shall be made to the nearest rupee or multiple thereof. *(RTP May 23)***

**Answer 21**

**In the Books of Remo Ltd.**
**9% Government Securities (Investment) Account**

| | | Face Value | Interest | Cost | Particulars | | Face Value | Interest | Cost |
|---|---|---|---|---|---|---|---|---|---|
| 2021 | | ₹ | ₹ | ₹ | 2021 | | ₹ | ₹ | ₹ |
| April 1 | To Balance b/d | 1,00,000 | 2,250 | 90,000 | June 1 | By Bank A/c | 60,000 | 2,250 | 54,150 |
| May 1 | To Bank A/c | 80,000 | 2,400 | 73,600 | June 30 | By Bank A/c | - | 5,400 | - |
| June 1 | To P&L A/c | - | - | 150 | Sept. 30 | By Bank A/c | 40,000 | 900 | 37,900 |
| Sept. 30 | To P & L A/c | - | - | 1,900 | Dec. 31 | By Bank A/c | - | 4,050 | - |
| Dec. 1 | To Bank A/c | 10,000 | 375 | 10,000 | Mar.1 2022 | By Bank A/c | 10,000 | 150 | 9,500 |
| Mar. 1 2022 | To P&L A/c | - | - | 300 | Mar. 31 2022 | By Balance c/d | 80,000 | 1,800 | 74,400 |
| Mar. 31, 2022 | To P&L A/c (Transfer) | - | 9,525 | - | | | | | |
| | | 1,90,000 | 14,550 | 1,75,950 | | | 1,90,000 | 14,550 | 1,75,950 |

**Working Notes:**

1. Interest accrued on 1st April 2021 = ₹1,00,000 x 9% x 3/12 = ₹ 2,250
2. Accrued Interest on 800 units as on 01 05.2021 = ₹ 80,000 x 9/100 x 4/12 = ₹ 2,400
3. Cost of Investment for purchase on 01.05.2021 = ₹ 76,000 - ₹ 2,400 = ₹ 73,600
4. Accrued Interest on 600 units as on 01 06.2021 = ₹ 60,000 x 9/100 x 5/12 = ₹ 2,250
5. Profit on Securities sold on 1st June = ₹ 54,150 (56,400 – 2,250)- ₹ 54,000 (60,000 x 90,000/1,00,000) = ₹ 150
6. Interest received on 30 06.2021 = ₹1,20,000 x 9/100 x 6/12 = ₹ 5,400
7. Accrued Interest on 400 units as on 30 09.2021 = ₹ 40,000 x 9/100 x 3/12 = ₹ 900
8. Cost of 400 Govt. Securities sold on 30.09.2021 = 40,000 x 90,000/1,00,000 = ₹ 36,000
9. Profit on securities sold on 30th September = ₹37,900 (38,800-900) - ₹ 36,000 = ₹ 1,900
10. Accrued Interest on 1 12.2021 = ₹ 10,000 x 9/100 x 5/12 = ₹ 375
11. Interest received on 31 12.2021 = ₹ 90,000 x 9/100 x 6/12 = ₹ 4,050
12. Accrued Interest on 100 units as on 01 03.2022 = ₹ 10,000 x 9/100 x 2/12 = ₹ 150

13. Cost of 100 Govt. Securities sold on 01.03.2022 = ₹ 10,000 x 73,600/80,000 = ₹ 9,200
14. Profit on securities sold on 01.03.2022 = ₹ 9,500 - ₹ 9,200 = ₹ 300 15

| **Calculation of closing balance:** | **Units** | **₹** |
|---|---|---|
| Securities in hand remained in hand at 31/3/2022 | | |
| From original holding (1,00,000 – 60,000 – 40,000) | | - |
| Purchased on 1st May (80,000 – 10,000) | 70,000 | 64,400 |
| Purchased on 1st December | 10,000 | 10,000 |
| | 80,000 | 74,400 |

## Question 22

**During the year ended 31st March, 2021, Purple Ltd. entered into the following transactions:**

| | |
|---|---|
| **1st April, 2020** | **Purchased ₹ 4,00,000, 10% Govt. loan 1(interest payable on 30th April and 31st October) at ₹ 70 cum interest.** |
| **1st April, 2020** | **Purchased 6,000 Equity shares of ₹ 5 each in XY Ltd. for ₹ 1,26,000.** |
| **1st October, 2020** | **Sold ₹ 80,000, 10% Govt. loan at ₹75 ex-interest.** |
| **15th January, 2021** | **XY Ltd. made a bonus issued of four equity shares for every three shares held. Purple Ltd. sold all of the bonus shares for ₹ 10 each.** |
| **1st March, 2021** | **Received dividend @ 22% on shares in XY Ltd. for the year ended 31st December, 2020.** |

**Prepare Investment accounts in the books of Purple Ltd.** ***(PYP 10 Marks , Dec '21)***

**Answer 22**

**In the books of Purple Ltd.**

**10% Govt. Loan [Interest Payable: 30th April & 31st October]**

| Date | Particulars | Nominal Value (₹) | Interest (₹) | Cost (₹) | Date | Particulars | Nominal Value (₹) | Interest (₹) | Cost (₹) |
|---|---|---|---|---|---|---|---|---|---|
| 1.4.20 | To Bank A/c (W.N.1) | 4,00,000 | 16,667 | 2,63,333 | 30.4.20 | By Bank A/c (4,00,000 x 10% x 6/12) | - | 20,000 | - |
| 1.10.20 | To Profit & Loss A/c (W.N 5) | | | 7,333 | 1.10.20 | By Bank A/c (W.N.2) | 80,000 | 3,333 | 60,000 |
| | | | | | 31.10.20 | By Bank A/c | - | 16,000 | - |
| 31.3.21 | To Profit & Loss A/c | | 35,999 | | 31.3.21 | By Balance c/d (W.N.3) | 3,20,000 | 13,333 | 2,10,666 |
| | | 4,00,000 | 52,666 | 2,70,666 | | | 4,00,000 | 52,666 | 2,70,666 |

**Investment in Equity Shares of XY Ltd. Account (of ₹ 5 each)**

| Date | Particulars | No. | Dividend (₹) | Cost (₹) | Date | Particulars | No. | Dividend (₹) | Cost |
|---|---|---|---|---|---|---|---|---|---|
| 1.4.20 | To Bank A/c | 6,000 | | 1,26,000 | 15.1.21 | By Bank A/c | 8,000 | 4,950 | 80, |
| 15.1.21<br>15.1.21 | To Bonus Issue<br>To Profit & Loss A/c. | 8,000 | | 8,000 | 1.3.21 | By Bank A/c (W.N.6) | | | 1, |
| 31.3.21 | (W.N.4)<br>To Profit & Loss A/c | | 4,950 | | 31.3.21 | By Balance c/d | 6,000 | | 52,3 |
| | | 14,000 | 4,950 | 1,34,000 | | | 14,000 | 4,950 | 1,34,00 |

**Working Notes:**

1. **Cost of investment purchased on 1st April, 2020**

   4,000, 10% Govt. loan were purchased @ ₹ 70 cum-interest. Total amount paid 4,000 bonds x ₹ 70 = 2,80,000 which includes accrued interest for 5 months, i.e., 1st November, 2020 to 31st March, 2021. Accrued interest will be ₹ 4,00,000 x 10% x 5/12 = ₹ 16,667. Therefore, cost of investment purchased = ₹

2,80,000 – ₹ 16,667 = ₹ 2,63,333.

2. **Sale of 10% Govt. loan on 1st October, 2020**
   800, 10% Govt. loan were sold@ ₹ 75 ex-interest, i.e., Total amount received = 800 x 75 + accrued interest for 5 months = ₹ 60,000 + ₹ 3333
3. **Cost of 10% Govt. loan on 31.3.2021**
   Cost of 10% Govt. loan on 31.3.2021 will be ₹ 2,63,333 x 3,20,000/4,00,000
   = ₹ 2,10,666.
   Interest accrued on 10% Government Loan on 31.3.2021 = ₹ 3,20,000 x 10% x 5/12
   = ₹ 13,333
4. **Profit on sale of bonus shares**
   Cost per share after bonus = ₹ 1,26,000/ 14,000 = ₹ 9 (average cost method being followed)
   Profit per share sold (₹ 10 – ₹ 9) = ₹ 1.
   Therefore, total profit on sale of 8,000 shares = 8,000 x ₹ 1 = ₹ 8,000.
5. **Profit on sale of 10% Govt. loan** ₹
   Sale value = 60,000
   Cost of ₹ 80,000 10% Government Loan = 2,63,333 x 80,000/ 4,00,000 = 52,667
   Profit=,333
6. **Dividend on equity shares = 6,000 x 5 x 22% = ₹ 6,600 out of which ₹ 1,650 will be treated as** capital receipt as it has been received for the period of 3 months during which shares were not held.

Note: It has been considered that dividend received relates for the period of 12 months ended 31st Dec., 2020, strictly based on the information, given in the Question. Hence, dividend received for the period of 3 months (1st January, 20 to 31st March, 20) has been treated as pre-acquisition.

## Question 23

**P Ltd. had 8,000 equity shares of K Ltd., at a book value of ₹ 15 per share (face value of ₹ 10 each) on 1st April,2019. On 1st September, 2019, P Ltd. acquired another 2,000 equity shares of K Ltd. at a premium of ₹ 4 per share. K Ltd. announced a bonus and right issue for existing shareholders.**

**The term of bonus and right issue were:**

**(i) Bonus was declared at the rate for two equity shares for every five shares held on 30th September, 2019.**

**(ii) Right shares are to be issued to the existing shareholders on 1st December, 219. The Company had issued two right shares for every seven shares held at 25% premium on face value. No dividend was payable on these shares. The whole sum being payable by 31st December, 2019.**

**(iii) Existing shareholders were entitled to transfer their right to outsiders either wholly or in part.**

**(iv) P Ltd. exercised its option under the issue for 50% of its entitlements and sold the remaining rights for ₹8 per share.**

**(v) Dividend for the year ended 31st March,2019 at the rate of 20% was declared by K Ltd. and received by P Ltd. on 20th January, 2020.**

**(vi) On 1st February, 2020, P Ltd. sold half of its shareholdings at a premium of ₹ 4 per share.**

**(vii) The market price of share on 31st March,2020 was ₹13 per share.**

**You are required to prepare the Investment account of P Ltd. for the year ended 31st March,2020 and determine the value of shares held on that date, assuming the investment as current investment. Consider average cost basis for ascertainment for cost for equity shares sold.** ***(PYP 10 Marks Jan 21)***

**Answer 23**

**Investment Account-Equity Shares in K Ltd.**

| Date | | No. of shares | Dividend | Amount | Date | | No. of shares | Dividend | Amount |
|---|---|---|---|---|---|---|---|---|---|
| | | | ₹ | ₹ | | | | ₹ | ₹ |
| 1.4.19 | To Bal.b/d | 8,000 | - | 1,20,000 | 20.1.20 | By Bank (dividend) [8,000 x 10 x 20%] and[2,000 x 10 x 20%] | | 16,000 | 4,000 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 1.9.19 | To Bank | 2,000 | - | 28,000 | 1.2.20 | By Bank | 8,000 | | 1,12,000 |
| 30.9.19 | To Bonus Issue | 4,000 | | – | | | | | |
| 31.12.19 | To Bank (Right) (W.N.1) | 2,000 | - | 25,000 | 31.3.20 | By Balance c/d (W.N. 3) | 8,000 | | 84,500 |
| 20.1.20 | To Profit & Loss A/c (Dividend income) | | 16,000 | | | | | | |
| 1.2.20 | To P& L A/c (profit on sale) | | | 27,500 | | | | | |
| | | 16,000 | 16,000 | 2,00,500 | | | 16,000 | 16,000 | 2,00,500 |

**Working Notes:**

1. **Right shares**

   No. of right shares issued = (8,000 + 2,000 + 4,000)/ 7 X 2= 4,000

   No. of right shares subscribed = 4,000 x 50% = 2,000 shares

   Value of right shares issued = 2,000 x ₹12.50 = ₹ 25,000

   No. of right shares sold = 2,000 shares

   Sale of right shares = 2,000 x ₹ 8 = ₹ 16,000 to be credited to statement of profit and loss

2. **Cost of shares sold — Amount paid for 16,000 shares**

| | ₹ |
|---|---|
| (₹1,20,000 + ₹ 28,000 + ₹ 25,000) | 1,73,000 |
| Less: Dividend on shares purchased on Sept.1 (since the dividend | (4,000) |
| pertains to the year ended 31st March, 2019, i.e., the pre-acquisition period) | |
| Cost of 16,000 shares | 1,69,000 |
| Cost of 8,000 shares (Average cost basis) | 84,500 |
| Sale proceeds (8,000 X ₹14) | 1,12,000 |
| Profit on sale | 27,500 |

3. **Value of investment at the end of the year**

   Assuming investment as current investment, closing balance will be valued based on lower of cost or net realizable value. Here, Net realizable value is ₹13 per share i.e., 8,000 shares x ₹ 13 = ₹ 1,04,000 and cost = 84,500. Therefore, value of investment at the end of the year will be ₹ 84,500.

## Question 24

**Mr. Saurabh held 10,000 equity shares of BT Limited on 1st April,2021. Nominal value of the shares is ₹ 2 each and their book value is ₹ 7 per share.**

- **On 4th July,2021 he purchased another 7,500 shares at ₹ 10 each.**
- **On 31st July 2021 the company announced a Bonus and Right issue.**
- **Bonus was declared of one share for every five shares held and was received on 5th August,2021.**
- **Right issue to be issued on 12th September,2021, which entitled the holders to subscribe to additional 2 shares for every 7 shares held at ₹ 2 per share. Shareholders were entitled to transfer their rights in full or part. Mr. Saurabh sold whole of his entitlements to Mr. Nihal at ₹ 1.50 per share.**
- **Dividend was declared for the year ended 31st March,2021 @ 25% and received by Mr. Saurabh on 19th September 2021.**
- **On 11th December 2021 Mr. Saurabh sold 7,500 shares at ₹ 8 per share.**
- **The market price of the shares on 31st March,2022 was ₹ 7 per share.**

**You are required to prepare the Investment Account of Mr. Saurabh on 31st March,2022 considering the above-mentioned points, also state the value of shares held on that date. (Assume investment as current investment)** ***(PYP 10 Marks Nov '22)***

**Answer 24**

### Investment Account in Books of Saurabh
### (Script: Equity Shares in BT Ltd.)

| | | No. | Divi- dend | Amount | | | No. | Divi- dend | Amount |
|---|---|---|---|---|---|---|---|---|---|
| | | | | ₹ | | | | | ₹ |
| 1.4.21 | To Bal b/d | 10,000 | | 70,000 | 19.9.2021 | By Bank (dividend on shares acquired on 4.7. 2021) | | 5,000 | 3,750 |
| 4.7.21 | To Bank | 7,500 | | 75,000 | | | | | |
| 5.8.21 | To Bonus | 3,500 | | 0 | | | | | |
| 11.12.21 | To P&L A/c (Profit on sale of shares) | | | 9,554 | 11.12.2021 | By Bank (Sale of shares) | 7,500 | | 60,000 |
| 31.3.22 | To P&L A/c | | 5,000 | | 31.3.2022 | By Bal. c/d | 13,500 | | 90,804 |
| | | 21,000 | 5,000 | 1,54,554 | | | 21,000 | 5,000 | 1,54,554 |

**Working Notes:**

(1) Right Shares = $\frac{(10,000+7,500+3,500)}{7} \times 2 = 6,000$

Sale of rights amounting ₹ 9,000 (₹ 1.5 x 6,000 shares)

It will not be shown in investment A/c but will directly be taken to P & L statement.

**(2) Profit on sale of 7,500 shares**

= Sales proceeds – Average cost

Sales proceeds = ₹ 60,000

Average cost = (70,000 + 75,000 – 3,750) /21,000 x 7,500 = ₹ 50,446

Profit = ₹ 60,000 – ₹ 50,446 = ₹ 9,554.

(3) **Value of investments**

Current investments are valued at lower of cost or net realizable value. Here, cost= (70,000 + 75,000 – 3,750)/ 21,000 X 13,500 = ₹ 90,804

Net realizable value of the shares = ₹ 94,500

Therefore, value of investments will be taken lower of above i.e.₹ 90,804

**Note:** As question is silent, Average cost basis has been considered for calculation of cost of shares in above solution. Alternatively, FIFO method can also be considered for calculation of cost of shares. An alternative solution is given below based on FIFO method-

**Alternative Solution**

**Investment Account in Books of Saurabh (Script: Equity Shares in BT Ltd.)**

| | | No. | Divid end | Amount | | | No. | Divid end | Amount |
|---|---|---|---|---|---|---|---|---|---|
| | | | | ₹ | | | | | ₹ |
| 1.4.21 | To Bal b/d | 10,000 | | 70,000 | 19.9.21 | By Bank (Dividend on shares acquired on 4.7. 2021) | | 5,000 | 3,750 |
| 4.7.21 | To Bank | 7,500 | | 75,000 | | | | | |
| 5.8.21 | To Bonus | 3,500 | | 0 | | | | | |
| 11.12.21 | To P&L A/c (Profit on sale of shares) | | | 7,500 | 11.12.21 | By Bank (Sale of shares) | 7,500 | | 60,000 |
| 31.3.22 | To P&L A/c | | 5,000 | | 31.3.22 | By Bal. c/d | 13,500 | | 88,750 |
| | | 21,000 | | 1,52,500 | | | 21,000 | | 1,52,500 |

**Working Note:**

**(1)** Right Shares = $\frac{(10,000+7,500+3,500)}{7} \times 2 = 6,000$

Sale of rights amounting ₹ 9,000 (₹ 1.5 x 6,000 shares)

It will not be shown in investment A/c but will directly be taken to P & L statement.

**(2) Profit on sale of 7,500 shares**

= Sales proceeds – Cost Sales proceeds = ₹ 60,000

Cost = 7,500 X ₹ 7= ₹ 52,500

Profit = ₹ 60,000 – ₹ 52,500 = ₹ 7,500.

**(3) Value of investments**

Current investments are valued at lower of cost or net realizable value Here, cost= (2500 X₹7) + (7500 X₹10) -₹3750 = ₹ 88,750

Net realizable value of the shares = ₹ 94,500

Therefore, value of investments will be taken lower of above i.e.₹ 88,750

## Question 25

**The following information is given for Mr. Atwood for the year ended 31.03.2023:**

| | |
|---|---|
| **01.04.2022** | **Mr. Atwood has 3,000 equity shares in Sun Limited at a book value of ₹ 3,30,000 (nominal value ₹ 100 each.)** |
| **01.07.2022** | **Purchased 1,500 equity shares in Sun Limited for ₹ 1,38,600.** |
| **01.08.2022** | **Purchased 5,000.9% Bonds at ₹ 97 cum-interest (face value ₹ 100). The due dates of interest are 1st September and 1st March.** |
| **02.10.2022** | **Dividend declared on equity shares and paid by Sun Limited for the year 2021- 2022 @ 10%.** |
| **15.10.2022** | **Sun Limited made a bonus issue of two equity shares for every five shares held.** |
| **01.01.2023** | **1,000 equity shares in Sun Limited sold @₹ 115 per share.** |
| **31.03.2023** | **Sold 4,000,9% Bonds @ ₹ 99 ex-interest** |

- **The market price of Equity Shares of Sun Limited is ₹ 125 each and Bonds ₹ 98 each on 31st March 2023.**
- **Interest on bonds was received on due dates.**

**You are required to prepare Investment Account in the books of Mr. Atwood for the year ended 31stMarch 2023, assuming that the investments are valued at the average cost or market value, whichever is lower. (Round off to nearest Rupee) *(PYP 10 Marks May '23)***

**Answer 25**

In the books of Atwood

**Investment in Equity Shares of Sun Ltd. Account**

| Date | Particulars | No. | Dividend | Amount | Date | Particulars | No. | Dividend | Amount |
|---|---|---|---|---|---|---|---|---|---|
| | | | (₹) | (₹) | | | | (₹) | (₹) |
| 1.04.22 | To Balance b/d | 3,000 | | 3,30,000 | 2.10.22 | By Bank A/c (W.N. 5) | | 30,000 | 15,000 |
| 1.07.22 | To Bank A/c | 1,500 | | 1,38,600 | 1.1.23 | By Bank A/c | 1,000 | | 1,15,000 |
| 15.10.22 | To Bonus Issue | 1,800 | | | 31.3.23 | By Balance c/d (W.N.7) | 5,300 | | 3,81,600 |
| 1.01.23 | To Profit & Loss A/c (W.N. 6) | | | 43,000 | | | | | |
| 31.3.23 | To Profit & Loss A/c | | 30,000 | | | | | | |
| | | 6,300 | 30,000 | 5,11,600 | | | 6,300 | 30,000 | 5,11,600 |

**9% Bonds Account [Interest Payable: 1st September & 1st March]**

| Date | Particulars | Nominal Value (₹) | Interest (₹) | Cost (₹) | Date | Particulars | Nominal Value (₹) | Interest (₹) | Cost (₹) |
|---|---|---|---|---|---|---|---|---|---|
| 1.8.22 | To Bank A/c (W.N.1) | 5,00,000 | 18,750 | 4,66,250 | 1.9.22 | By Bank A/c (5,00,000 x 9% x 6/12) | - | 22,500 | - |
| 31.3.23 | To Profit & Loss A/c (W.N 3) | | | 23,000 | 1.3.23 | By Bank A/c | - | 22,500 | - |
| | | | | | 31.3.23 | By Bank A/c (W.N 2) | 4,00,000 | 3,000 | 3,96,000 |
| 31.3.23 | To Profit & Loss A/c | | 30,000 | | 31.3.23 | By Balance c/d (W.N.4) | 1,00,000 | 750 | 93,250 |
| | | 5,00,000 | 48,750 | 4,89,250 | | | 5,00,000 | 48,750 | 4,89,250 |

**Working Notes:**

1. **Cost of Bond purchased on 1st August, 2022**

   5,000, 9% bonds were purchased @ ₹ 97 cum-interest. Total amount paid 5,000 bonds x ₹ 97 = 4,85,000 which includes accrued interest for 5 months, i.e., 1st March, 2022 to 31st July, 2022. Accrued interest will be ₹ 5,00,000 x 9/100x 5/12 = ₹ 18,750. Therefore, cost of Bond purchased = ₹ 4,85,000 – 18,750 = ₹ 4,66,250.

2. **Sale of bonds on 31st March, 2023**

   4,000 bonds were sold@ ₹ 99 ex-interest, i.e., Total amount received = 4,000 x 99 + accrued interest for 1 month = ₹ 3,96,000 + ₹ 3,000 (4,00,000 x 9/100 x 1/12)

3. **Profit on sale of bonds** ₹

   Sale value = 3,96,000

   Cost of 4,00,000 9% bonds = 4,66,250/5,000x 4,000 = 3,73,000

   Profit = **23,000**

4. **Value of bonds on 31.3.2023** Lower of:

   Cost of bonds on 31.3.2023 will be ₹ 4,66,250/ 5,000 x 1,000 = ₹ 93,250.

   Market Value on 31.3.2023 will be ₹ 1,000 X 98 = 98,000

   Value of bonds on 31.3.2023 = ₹ 93,250

   nterest accrued on bonds on 31.3.2023 = 1,00,000 x 9% x 1/12 = ₹ 750

5. **Dividend on equity shares for 2021-22**

   Post acquisition dividend = 3,00,000 x 10% = ₹ 30,000 transferred to Profit & Loss account

   Pre-acquisition dividend = 1,50,000 X 10% = ₹ 15,000 credited to investment A/c

6. **Profit on sale of equity shares**

   ₹Sale value = 1,15,000

   Cost of shares = 4,53,600 / 6,300 x 1,000 = 72,000 Profit = 43,000

   (Average cost method being followed)

7. **Value of equity shares at end of year**

   Lower of: Cost of shares on 31.3.2023 will be ₹ 4,53,600 / 6,300 x 5,300 = ₹ 3,81,600

   Market Value on 31.3.2023 will be ₹ 5,300 x 125 = 6,62,500

   Value of shares = ₹ 3,81,600

## Question 26

**Following information is given by Mr. Happy (stock broker) relating to his holding in 10% Government Bonds:**

**Opening Balance as on 1st April, 22 was 5,000 units (Nominal value ₹ 100 each), Cost ₹ 4,85,000**

**On 1st June, 22, Purchased 600 units, cum-interest @ ₹ 99**

**On 1st August, 22, Purchased 2400 units, ex-interest @ ₹ 97.50 On 1st October, 22, Sold 2,500 units @ ₹ 98.50, ex-interest**

**On 1st January, 23, Sold 3,000 units @ ₹ 99 cum interest**

**Interest is received on 30th June and 31st December each year. Mr. Happy closes his books on 31st March each year.**

Prepare Investment Account in the books of Mr. Happy assuming that FIFO method of valuation is followed by Mr. Happy. *(PYP 10 Marks Nov'23) (Same concept Different Figure SM)*

**Answer 26**

**In the Books of Mr. Happy**

**10% Government Bonds (Investment) Account**

| Particulars | | Nominal Value | Interest | Principal | Particulars | | Nominal Value | Interest | Principal |
|---|---|---|---|---|---|---|---|---|---|
| 2022-23 | | ₹ | ₹ | ₹ | 2022-23 | | ₹ | ₹ | ₹ |
| April1 | To Balance b/d (W.N.1) | 5,00,000 | 12,500 | 4,85,000 | June. 30 | By Bank A/c (W.N.3) | | 28,000 | |
| June 1 | To Bank A/c (W.N.2) | 60,000 | 2,500 | 56,900 | Oct. 1 | By Bank A/c (W.N.4) | 2,50,000 | 6,250 | 2,46,250 |
| | | | | | Dec.31 | By Bank A/c (W.N.6) | | 27,500 | |
| Aug. 1 | To Bank A/c | 2,40,000 | 2,000 | 2,34,000 | Jan. 1 | By Bank A/c (W.N.7) | 3,00,000 | | 2,97,000 |
| Oct. 1 | To P&L A/c (W.N.5) | | | 3,750 | March 31 | By Balance c/d (W.N. 9 & W.N.10) | 2,50,000 | 6,250 | 2,43,483 |
| Jan. 1 | To P&L A/c (b.f.) (W.N.8) | | | 7,083 | | | | | |
| March 31 | To P&L A/c (Transfer) | | 51,000 | | | | | | |
| | | 8,00,000 | 68,000 | 7,86,733 | | | 8,00,000 | 68,000 | 7,86,733 |

**Working Notes:**

1. Interest element in opening balance of bonds = 5,00,000 x 10% x 3/12 = ₹ 12,500
2. Purchase of bonds on 1.6.22
   Interest element in purchase of bonds = 600 x 100 x 10% x 5/12 = ₹ 2,500
   Investment element in purchase of bonds = (600 X 99) = ₹ 59,400 - ₹ 2,500 = 56,900
3. Interest for half-year ended 30.6.22 = ₹ 5,60,000 x 10% x 6/12 = ₹ 28,000
4. Sale of bonds on 1.10.2022
   Interest element = 2,500 x 100 x 10% x 3/12 = ₹ 6,250
   Investment element = 2,500 x 98.50 = ₹ 2,46,250
5. Profit on sale of bonds on 1.10.22
   Cost of bonds = (4,85,000/5,000 X 2,500) = 2,42,500
   Sale proceeds = ₹ 2,46,250 Profit element = ₹ 3,750
6. Interest for half-year ended 31 December 2022
   = 5,500 x 100 x 10% x 6/12 = ₹ 27,500
7. Sale of bonds on Jan.1 ,23 Interest element = 0 (Nil)
   Investment element = 3000 x ₹ 99 = ₹2,97,000
8. Profit on sale of bonds on Jan 1, 23
   Cost of bonds = [2,42,500+56,900X5/6] = 2,42,500 + 47,417 = 2,89,917
   Sale proceeds = ₹ 2,97,000 Profit element = ₹ 7,083
9. Closing value of investment

| Calculation of closing balance: | Nominal value | ₹ |
|---|---|---|

| | | |
|---|---|---|
| Bonds in hand remained in hand on 1.4.22 | | --- |
| Purchased on 1st June,22 | 10,000 | 9,483 |
| Purchased on 1st August,22 | 2,40,000 | 2,34,000 |
| | 2,50,000 | 2,43,483 |

10. Interest element in closing balance of bonds = 2,500 x 100 x 10% x 3/12 = ₹6,250.

## Question 27

**Sanket had 50,000 Equity shares of XYZ Ltd. on 01.01.2022 at a book value of ₹ 25 per share (face value ₹ 10). On 01.06.2022, he purchased another 10,000 shares of the company at ₹ 20 per share.**
**The director of XYZ Ltd. announces a bonus and right issue. No dividend was payable on these issues. The terms of the issue were as follows:**

- **Bonus basis 1:6 (Date: 16.08.2022)**
- **Right basis 3: 7 (Date: 31.08.2022) price ₹15 per share**
- **Due date for payment 30.09.2022**
- **Shareholders can transfer their rights in full or in part.**

**Accordingly, Sanket sold 33 1/3% of his entitlement in the market for consideration of ₹ 4 per share on 31.08.2022 & he procured other entitlement by payment.**
**Dividends for the year ended 31.03.2022 at the rate of 20% were declared by XYZ Ltd. and received by Sanket on 31.10.2022. Dividend amount for shares acquired by him on 01.06.2022 are to be adjusted against the cost of purchase.**
**On 15.11.2022, Sanket sold 25,000 equity shares at premium ₹ 12 per share. You are required to prepare in books of Sanket.**
**(i) Investment Account**
**(ii) Profit & Loss Account (Extract for Investment)**
**Books of accounts are closed by Sanket on 31.12.2022 and market price of shares on that date is ₹ 20 per share.** ***(RTP 10 Marks March '23)(Same concept different figures SM)***

**Answer 27**

**Books of Sanket**
**Investment Account (Scrip: Equity Shares in XYZ Ltd.)**

| | | No. | Amount ₹ | | | No. | Amount ₹ |
|---|---|---|---|---|---|---|---|
| 1.1.2022<br>1.6.2022 | To Bal b/d To Bank | 50,000<br>10,000 | 12,50,000<br>2,00,000 | 31.10.2022 | By Bank (dividend | - | 20,000 |
| 16.8.2022<br><br>30.9.2022 | To Bonus (W.N.1)<br>To Bank (Rights Shares) (W.N.3) | 10,000<br><br>20,000 | -<br>3,00,000 | | On shares acquired on 1.6.2022) (W.N.4) | | |
| 15.11.2022 | To Profit (on sale of shares) | | 69,444 | 15.11.2022 | By Bank (Sale of shares) | 25,000 | 5,50,000 |
| | | | | 31.12.2022 | By Bal. c/d (W.N.6) | 65,000 | 12,49,444 |
| | | 90,000 | 18,19,444 | | | 90,000 | 18,19,444 |

**Profit and Loss Account (An extract for investment)**

| | | | |
|---|---|---|---|
| 31.12.2022 To Balance c/d (profit) | 2,09,444 | 31.8.22 By Sale of rights (W.N.3) | 40,000 |
| | | 31.10.22 By Dividend (W.N.4) | 1,00,000 |
| | | 15.11.22 By Profit transferred | 69,444 |
| | 2,09,444 | | 2,09,444 |

Working Notes:

(1) Bonus Shares = $\frac{(50,000+10,000)}{6}$ = 10,000 shares

(2) Right Shares = $\frac{(50,000+10,000+10,000)}{7}$ $X$ 3 = 30,000 shares × 2/3 = 20,000 shares

(3) Right shares renounced = 30,000×1/3 = 10,000 shares Sale of right shares = 10,000 x 4 = ₹ 40,000
Right shares subscribed = 20,000 shares

Amount paid for subscription of right shares = 20,000 x 15 = ₹ 3,00,000

(4) Dividend received = 50,000 (shares as on 1st April 2022) × 10 × 20% = ₹ 1,00,000
Dividend on shares purchased on 1.6.2022 = 10,000×10×20% = ₹ 20,000 is adjusted to Investment A/c

(5) Profit on sale of 25,000 shares = Sales proceeds – Average cost Sales proceeds = ₹ 5,50,000

Average cost = $\frac{(12,50,000+2,00,000+3,00,000-20,000)}{90,000} \times 25000 =$ ₹ 4,80,556

Profit = ₹ 5,50,000 – ₹ 4,80,556 = ₹ 69,444.

(6) Cost of shares on 31.12.2022 $\frac{(17,30,000)}{90,000} X\ 65,000 =$ ₹ 12,49,444

Market value of share = 65,000 shares × ₹ 20 = 13,00,000

Shares will be valued at ₹ 12,49,444 as market value is more than cost.

## Question 28

**Following transactions of Meeta took place during the financial year 2020 -21:**

| | |
|---|---|
| 1st April, 2020 | Purchased ₹ 4,500 8% bonds of ₹ 100 each at ₹ 80.50 cum-interest. Interest is payable on 1st November and 1st May. |
| 1st May, 2020 | Received half year's interest on 8% bonds. |
| 10 July, 2020 | Purchased 6,000 equity shares of ₹ 10 each in Kamal Limited for ₹ 44 each through a broker, who charged brokerage @ 2%. |
| 1st October 2020 | Sold 1,125 8% bonds at ₹ 81 Ex-interest. |
| 1st November, 2020 | Received half year's interest on 8% bonds. |
| 15th January, 2021 | Received 18% interim dividend on equity shares of Kamal Limited. |
| 15th March, 2021 | Kamal Limited made a rights issue of one equity share for every four Equity shares held at ₹ 5 per share. Meeta exercised the option for 40% of her entitlements and sold the balance rights in the market at ₹ 2.25 per share. |

**Prepare separate investment account for 8% bonds and equity shares of Kamal Limited in the books of Meeta for the year ended on 31st March, 2021. Assume that the average cost method is followed. *(RTP Nov 21, PYP Nov '18 , 10 Marks)***

**Answer 28**

**In the books of Meeta**

**8% Bonds for the year ended 31st March, 2021**

| Date | Particulars | No. | Income ₹ | Amount ₹ | Date | Particulars | No. | Income ₹ | Amount ₹ |
|---|---|---|---|---|---|---|---|---|---|
| 2020 1 April, Oct. 1 | To Bank A/c | 4,500 | 15,000 | 3,47,250 | 1 May 2020 | By Bank-Interest | - | 18,000 | |
| 2021 March 31 | To P & L A/c (W.N.1) | - | - | 4,312.50 | 1 Oct. 2020 | By Bank A/c | 1,125 | 3,750 | 91,125 |
| | To P & L A/c | | 20,250 | | 1 Nov. 2021 | By Bank-Interest | | 13,500 | |
| | | | | | 2021 Mar. 31 | By Balance c/d (W.N.2) | 3,375 | - | 2,60,437.50 |
| | | 4,500 | 35,250 | 3,51,562.50 | | | 4,500 | 35,250 | 3,51,562.50 |

**Investment in Equity shares of Kamal Ltd. for the year ended 31 st March, 2021**

| Date | Particulars | No. | Income ₹ | Amount ₹ | Date | Particulars | No. | Income ₹ | Amount ₹ |
|---|---|---|---|---|---|---|---|---|---|
| 2020 July 10 | To Bank A/c | 6,000 | - | 2,69,280 | 2021 Jan 15 | By Bank dividend | - | 10,800 | |
| 2021 March 15 | To Bank A/c (W.N. 3) | 600 | - | 3,000 | March 31 | By Balance c/d (bal.fig.) | 6,600 | | 2,72,280 |
| March 31 | To P & L A/c | - | 10,800 | | | | | | |
| | | 6,600 | 10,800 | 2,72,280 | | | 6,600 | 10,800 | 2,72,280 |

**Working Notes:**

1. **Profit on sale of 8% Bonds**
   Sales price ₹ 91,125
   **Less:** Cost of bonds sold = 3,47,250/4,500x 1,125 (₹ 86,812.50)
   Profit on sale ₹ 4,312.50
2. **Closing balance as on 31.3.2021 of 8 % Bonds**
   3,47,250/4,500x 3,375= ₹ 2,60,437.50
3. **Calculation of right shares subscribed by Kamal Ltd.**
   Right Shares = 6,000/4 x 1= 1,500 shares
   Shares subscribed by Meeta = 1,500 x 40%= 600 shares
   Value of right shares subscribed = 600 shares @ ₹ 5 per share = ₹ 3,000
4. **Calculation of sale of right entitlement by Kamal Ltd.**
   No. of right shares sold = 1,500 – 600 = 900 rights for 2,025

**Note:** As per para 13 of AS 13, sale proceeds of rights are to be credited to P & L A/c.

## Question 29

LDR

**Mr. Vijay entered into the following transactions of purchase and sale of equity shares of JP Power Ltd. The shares have paid up value of ₹ 10 per share.**

| Date | No. of Shares | Terms |
|---|---|---|
| 01.01.2019 | 600 | Buy @ ₹ 20 per share |
| 15.03.2019 | 900 | Buy @ ₹ 25 per share |
| 20.05.2019 | 1000 | Buy @ ₹ 23 per share |
| 25.07.2019 | 2500 | Bonus Shares received |
| 20.12.2019 | 1500 | Sale @ ₹ 22 per share |
| 01.02.2020 | 1000 | Sale @ ₹ 24 per share |

**Addition information:**

1. **On 15.09.2019 dividend @ ₹ 3 per share was received for the year ended 31.03.2019.**
2. **On 12.11.2019 company made a right issue of equity shares in the ratio of one share for five shares held on payment of ₹ 20 per share. He subscribed to 60% of the shares and renounced the remaining shares on receipt of ₹ 3 per share.**
3. **Shares are to be valued on weighted average cost basis.**
   **You are required to prepare Investment Account for the year ended 31.03.2019 and 31.03.2020. *(MTP 8 Marks Mar'22, Oct 20, PYP May '18 10 Marks)***

**Answer 29**

**Investment in Equity shares of JP Power Ltd.**

| Date | Particulars | No. | Dividend ₹ | Amount ₹ | Date | Particulars | No. | Dividend ₹ | Amount ₹ |
|---|---|---|---|---|---|---|---|---|---|
| 1.1.19 | To Bank A/c | 600 | | 12,000 | 31.3.19 | By Balance c/d | 1,500 | | 34,500 |
| 15.3.19 | To Bank A/c | 900 | | 22,500 | | | | | |
| | | 1,500 | | 34,500 | | | 1,500 | | 34,500 |
| 1.4.19 | To Balance b/d | 1,500 | | 34,500 | 15.9.19 | By Bank dividend | | 4,500 | 3,000 |
| 20.5.19 | To Bank A/c | 1,000 | | 23,000 | 20.12.19 | By Bank | 1,500 | | 33,000 |
| 25.7.19 | To Bonus shares | 2,500 | | _ | 1.2.20 | By Bank | 1,000 | | 24,000 |
| 12.11.19 | To Bank A/c | 600 | | 12,000 | 31.3.20 | By Balance c/d | 3,100 | | 36,812.50 |
| 20.12.19 | To P& L A/c (profit on sale) | | | 15,187.50 | | | | | |
| 1.2.20 | To P& L A/c (profit on sale) | | | 12,125 | | | | | |
| 31.3.20 | To P & L A/c (dividend) | | 4,500 | | | | | | |
| | | 5,600 | 4,500 | 96,812.50 | | | 5,600 | 4,500 | 96,812.50 |

**Working Notes:**

1. **Calculation of Weighted average cost of equity shares**

   600 shares purchased at ₹ 12,000
   900 shares purchased at ₹ 22,500
   1,000 shares purchased at ₹ 23,000
   2,500 shares at nil cost
   600 right shares purchased at ₹ 12,000
   The total cost of 5,600 shares is ₹ 66,500 [₹ 69,500 less ₹ 3,000 (pre-acquisition dividend received on 1,000 shares purchased on 20.5.19].
   Hence, weighted average cost per share will be considered as ₹ 11.875 per share (66,500/5,600).

2. **It has been considered that no dividend was received on bonus shares as the dividend pertains to the year ended 31set March, 2019.**

3. **Calculation of right shares subscribed by Vijay Right Shares (considering that right shares have been granted on Bonus shares also) = 5,000/5 x 1= 1,000 shares**

   Shares subscribed = 1,000 x 60%= 600 shares
   Value of right shares subscribed = 600 shares 20 per share = ₹ 12,000 Calculation of sale of right renouncement
   No. of right shares sold = 1,000 x 40% = 400 shares
   Sale value of right = 400 shares x ₹ 3 per share = ₹ 1,200
   Note: As per para 13 of AS 13, sale proceeds of rights is to be credited to P & L A/c.

4. **Profit on sale of equity shares**

| | | |
|---|---|---|
| As on 20.12.1 | | |
| Sales price | (1,500 shares at ₹ 22) | 33,000.00 |
| *Less*: Cost of shares sold | 1,500 x ₹ 11.875) | (17,812.50) |
| Profit on sale | | 15,187.50 |
| Sales price | (1,000 shares at ₹ 24) | 24,000 |
| *Less*: Cost of shares sold | (1,000 x ₹ 11.875) | (11,875) |
| Profit on sale | | 12,125 |

## Question 30

**A Ltd. purchased on 1st April, 2022 8% convertible debenture in C Ltd. of face value of ₹ 2,00,000 @ ₹ 108. On 1st July, 2022 A Ltd. purchased another ₹ 1,00,000 debentures @ ₹ 112 cum interest. On 1st October, 2022 ₹ 80,000 debentures were sold @ ₹ 105. On 1st December, 2022, C Ltd. give option for conversion of 8% convertible debentures into equity share of ₹ 10 each. A Ltd. received 5,000 equity shares in C Ltd. in conversion of 25% debentures held on that date. The market price of debenture and equity share in C Ltd. on 31st December, 2022 is ₹ 110 and ₹ 15 respectively. Interest on debenture is payable each year on 31 st March, and 30th September. Prepare investment account in the books of A Ltd. on average cost basis for the accounting year ended 31st December, 2022. *(MTP 8 Marks April 23, April '22 ,April '21 & Oct '23, MTP 10 Marks Aug'24, RTP May 19)***

**Answer 30**

**Investment Account for the year ending on 31st December, 2022**
**Scrip : 8% Convertible Debentures in C Ltd.**
**[Interest Payable on 31st March and 30th September]**

| Date | Particulars | Nominal value Rs. | Interest Rs. | Cost Rs. | Date | Particulars | Nominal Value Rs. | interest Rs. | Cost (Rs. |
|---|---|---|---|---|---|---|---|---|---|
| 1.4.22 | To Bank A/c | 2,00,000 | - | 2,16,000 | 30.09.2022 | By Bank A/c | - | 12,000 | |
| 1.7.22 | To Bank A/c (W.N.1) | 1,00,000 | 2,000 | 1,10,000 | | [3,00,000 X 8% x (6/12] | | | |
| 31.12.22 | To P & L A/c | | 14,033 | - | 1.10.2022 | By Bank A/ c | 80,000 | | 84,000 |
| | [Interest] | | | | 1.10.2022 | By P & LA/c (loss) (W.N.3) | | | 2,933 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 1.12.2022 | By Bank A/c (Accrued interest) (T 55,000 x 08 x 2/12) | | 733 | |
| | | | | | 1.12.2022 | By Equity shares in C Ltd. (W.N.3 and 4) | 55,000 | | 59,767 |
| | | | | | 31.12.2022 | By Balance c/d (W.N.5) | 1,65,000 | 3,300 | 1,79,300 |
| | | 3,00,000 | 16,033 | 3,26,000 | | | 3,00,000 | 16,033 | 3,26,000 |

**SCRIP: Equity Shares in C LTD.**

| Date | Particulars | Cost (Rs.) | Date | Particulars | Cost (Rs.) |
|---|---|---|---|---|---|
| 1.12.2022 | To 8 % debentures | 59,767 | 31.12.2022 | By balance c/d | 59,767 |

**Working Notes:**

(i) Cost of Debenture purchased on 1st July = Rs. 1,12,000 — Rs. 2,000 (Interest)
= Rs. 1,10,000

(ii) Cost of Debentures sold on 1st Oct. = (Rs.2,16,000 + Rs. 1,10,000) x 80,000/3,00,000 = ₹ 86,933

(iii) Loss on sale of Debentures = Rs. 86,933— Rs.84,000 = ₹2,933

(iv) Nominal value of debentures converted into equity shares =₹55,000
[(Rs. 3,00,000 — 80,000) x.25]

$$\frac{Interest\ received\ before\ the\ conversion\ of\ debentures}{Interest\ on\ 25\%\ of\ total\ debentures\ =\ 55,000\ x\ 8\%\ x\ 2/ =\ 733}$$



(v) Cost of Debentures converted = (Rs. 2,16,000 + Rs. 1,10,000) x 55,000/3,00,000 = Rs. 59,767

(vi) Cost of closing balance of Debentures = (Rs. 2,16,000 + Rs.1,10,000) x 1,65,000 /3,00,000 = Rs. 1,79,300

(vii) Closing balance of Debentures has been valued at cost.

(viii) 5,000 equity Shares in C Ltd. will be valued at cost of Rs. 59,767 being lower than the market value Rs. 75,000 (Rs. 15 x5,000)

Note: It is assumed that interest on debentures, which are converted into cash, has been received at the time of conversion.

## Question 31

**WIWITZU Ltd. holds 2,000, 15% Debentures of ₹ 100 each in XYZ Ltd. as on April 1, 2022 at a cost of ₹ 2,50,000.**

**Interest is payable on June, 30 and December, 31 each year.**

**Following are the details of 15% Debentures purchased and sold during the year 2022-23.**

| Particulars |
|---|
| On May 1, 2022, 1,000 debentures are purchased cum-interest at ₹ 1,05,000. |
| On November 1, 2022, 1200 debentures are sold ex-interest at ₹ 1,28,200. |
| On November 30, 2022, 500 debentures are purchased ex-interest at ₹ 54,500. |
| On December 31, 2022, 900 debentures are sold cum-interest for ₹ 1,18,000 |

**You are required to prepare the investment Account showing value of holdings on March 31, 2023 at cost, using FIFO Method.** ***(RTP May'24) (Same Concept Different figures MTP 10 Marks Oct '22 & April '19)***

**Answer 31**

**In the Books of WIWITZU Ltd 15% Debentures (Investment) Account**

| Particulars | | Face Value | Interest | Principal | Particulars | | Face Value | Interest | Principal |
|---|---|---|---|---|---|---|---|---|---|
| | | ₹ | ₹ | ₹ | | | ₹ | ₹ | ₹ |
| 1.4.22 | To Balance b/d | 2,00,000 | 7,500 | 2,50,000 | 30.6.22 | By Bank A/c | | 22,500 | |
| | | | | | 1.11.22 | By Bank A/c | 1,20,000 | 6,000 | 1,28,200 |
| 1.5.22 | To Bank A/c | 1,00,000 | 5,000 | 1,00,000 | 1.11.22 | By P&L A/c | | | 21,800 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | 31.12.22 | By Bank A/c | 90,000 | 6,750 | 1,11,250 |
| 30.11.22 | To Bank A/c | 50,000 | 3,125 | 54,500 | 31.12.22 | By Bank A/c | | 10,500 | |
| 31.12.22 | To P&L A/c | | | 1,250 | 31.3.23 | By Balance c/d | 1,40,000 | 5,250 | 1,44,500 |
| 31.3.23 | To P&L A/c | | 35,375 | | | | | | |
| | (Transfer) | 3,50,000 | 51,000 | 4,05,750 | | | 3,50,000 | 51,000 | 4,05,750 |

**1.** Loss on sale of debentures on 1.11.22 Cost = 2,50,000/2,000X 1,200 = ₹ 1,50,000
Sale proceeds = ₹ 1,28,200
Loss = ₹ 1,50,000 less ₹ 1,28,200 = ₹ 21,800

**2.** Profit on sale of debentures on 31.12.22
Cost = 2,50,000/2,000X 800 + 1,00,000/1,000X 100 = ₹ 1,10,000 (1,00,000+10,000)
Sale proceeds = ₹ 1,11,250
Loss = ₹ 1,11,250 less ₹ 1,10,000 = ₹ 1,250

**3.**

| **Calculation of closing balance:** | **Units** | | **₹** |
|---|---|---|---|
| Debentures in hand remained in hand at 1.4.23 | | | |
| Purchased on 1st May, 22 | 900 | 1,00,000 x 9/10 | 90,000 |
| Purchased on 30th Nov. 22 | 500 | 54,500 | 54,500 |
| | 1,400 | | 1,44,500 |

## Question 32

LDR

**Mr. Z has made following transactions during the financial year 2020-21: Investment 1: 8% Corporate Bonds having face value ₹ 100.**

| Date | Particulars |
|---|---|
| 01-06-2020 | Purchased 36,000 Bonds at ₹ 86 cum-interest. Interest is payable on 30th September and 31st March every year |
| 15-02-2021 | Sold 24,000 Bonds at ₹ 92 ex-interest |

**Interest on the bonds is received on 30th September and 31st March. Investment 2 : Equity Shares of G Ltd having face value ₹ 10**

| Date | Particulars |
|---|---|
| 01-04-2020 | Opening balance 8000 equity shares at a book value of ₹ 190 per share |
| 01-05-2020 | Purchased 7,000 equity shares@ ₹ 230 on cum right basis; Brokerage of 1% was paid in addition. |
| 15-06-2020 | The company announced a bonus issue of 2 shares for every 5 shares held |
| 01-08-2020 | The company made a rights issue of 1 share for every 7 shares held at₹ 230 per share. The entire money was payable by 31.08.2020 |
| 25-08-2020 | Rights to the extent of 30% of his entitlements was sold @ ₹ 75 per share. The remaining rights were subscribed. |
| 15-09-2020 | Dividend @ ₹ 6 per share for the year ended 31.03.2020 was received on 16.09.2020. No dividend payable on Right issue and Bonus issue. |
| 01-12-2020 | Sold 7 ,000 shares @ 260 per share. Brokerage of 1% was incurred extra. |
| 25-01-2021 | Received interim dividend @ ₹ 3 per share for the year 2020-21. |
| 31-03-2021 | The shares were quoted in the stock exchange @ ₹ 260. |

**Both investments have been classified as Current investment in the books of Mr. Z. On 15th May 2021, Mr. Z decides to reclassify investment in equity shares of Z Ltd. as Long term Investment. On 15th May 2021, the shares were quoted in the stock exchange @ ₹ 180.**

**You are required to:**

**(i) Prepare Investment Accounts in the books of Mr. Z for the year 2020-21, assuming that the average cost method is followed.**

**(ii) Profit and loss Account for the year 2020-21, based on the above information.**

***(iii)* Suggest values at which investment in equity shares should be reclassified in accordance with AS 13.**
***(PYP July'21, 20 Marks MTP 15 Marks Sep '23)***

**Answer 32**

**I. In the books of Mr. Z**

**Investment in 8% Corporate Bonds Account For the period 01 April 2020 to 31 March 2021**

| Date | Particulars | Nos | Interest (₹) | Amount (₹) | Date | Particulars | Nos | Interest (₹) | Amount (₹) |
|---|---|---|---|---|---|---|---|---|---|
| 1/6/20 | To Bank A/c (WN1) | 36,000 | 48,000 | 30,48,000 | 30/9/20 | By Bank A/c (Interest 36,000 x 100 x 8% x 6/12) | | 1,44,000 | |
| 15/2/21 | To Profit & Loss A/c (WN 3) | | | 1,76,000 | 15/2/21 | By Bank A/c (WN2) | 24,000 | 72,000 | 22,08,000 |
| 31/3/21 | To Profit & Loss A/c | | 2,16,000 | | 31/3/21 | By Bank A/c (Interest 12,000 x 100 x 8% x 6/12) | | 48,000 | |
| | | | | | | By Balance c/d (WN 4) | 12,000 | | 10,16,000 |
| | Total | 36,000 | 2,64,000 | 32,24,000 | | Total | 36,000 | 2,64,000 | 32,24,000 |

**Note:** For computing the interest on the bonds sold on 15 Feb 2021, if number of days (138 days) is taken instead of months, the interest received on 15.02.2021 should be ₹72,592 and the total interest transferred to Profit & Loss Account should be ₹ 2,16,592. Wrongly printed as Z Ltd. in the Question paper. It should have been given as G Ltd.

**Investment in Equity Shares of G Ltd**
**For the period 1st April 2020 to 31 March 2021**

| Date | Particulars | Nos | Dividend (₹) | Amount (₹) | Date | Particulars | Nos | Dividend (₹) | Amount (₹) |
|---|---|---|---|---|---|---|---|---|---|
| 01/4/20 | To Balance b/d | 8,000 | | 15,20,000 | 16/9/20 | By Bank A/c (WN 7) | | 48,000 | 42,000 |
| 01/5/20 | To Bank A/c (WN 5) | 7,000 | | 16,26,100 | 1/12/20 | By Bank A/c (WN 8) | 7000 | | 18,01,800 |
| 15/6/20 | To Bonus Shares | 6,000 | | | 25/1/21 | By Bank A/c (WN 10) | | 48,300 | |
| 25/8/20 | To Bank A/c (Right Shares) (WN 6) | 2,100 | | 4,83,000 | | | | | |
| 01/12/20 | To Profit & Loss A/c (Sale of shares) (WN 9) | | | 7,14,800 | | | | | |
| 31/3/21 | To Profit & Loss A/c | | 96,300 | | 31/3/21 | By Balance c/d (WN 11) | 16,100 | | 25,00,100 |
| | Total | 23,100 | 96,300 | 43,43,900 | | Total | 23,100 | 96,300 | 43,43,900 |

**Working Notes**

**1. Computation of the Interest element in the bonds purchased on 01 June 2020**

| | |
|---|---|
| No of Bonds purchased | 36,000 |
| Face value per bond | ₹ 100 |
| Face value of the bonds purchased | ₹ 36,00,000 |
| Interest Rate | 8% |
| Interest Amount | 36,00,000 x 8% x 2/12 |
| | ₹ 48,000 |
| Cum-interest per bond | ₹ 86 |
| Value of bond excluding interest | 36,000 x 86 – 48,000 |

| | |
|---|---|
| | ₹ 30,48,000 |

2. **Computation of the Interest element in the bonds sold on 15 Feb 2021**

| | |
|---|---|
| No of Bonds sold | 24,000 |
| Face value per bond | ₹ 100 |
| Face value of the bonds sold | ₹ 24,00,000 |
| Interest Rate | 8% |
| Interest Amount | 24,00,000 x 8% x 4.5/12 = ₹ 72,000 |

3. **Computation of Profit on Sale of Bonds on 15 Feb 2021**

| | |
|---|---|
| No of Bonds sold | 24,000 |
| Face value per bond | ₹ 100 |
| Ex- interest Rate per bond | ₹ 92 |
| Sales proceeds | ₹ 22,08,000 |
| Average Cost of Bonds | (30,48,000/36,000) x 24,000 |
| | ₹ 20,32,000 |
| Profit on sale of bonds | Sale Proceeds – Average Cost |
| | 22,08,000 – 20,32,000 |
| | ₹ 1,76,000 |

4. **Valuation of Bonds as on 31 March 2021**

| | |
|---|---|
| No of Bonds held as on 31 Mar 2021 | 12,000 |
| Average Cost of Bonds | (30,48,000/36,000) x 12,000 |
| | ₹ 10,16,000 |

5. **Computation of the cost of the equity shares purchased on 01 May 2020**

| | |
|---|---|
| No of shares purchased | 7,000 |
| Cum right price per share | ₹ 230 |
| Cost of purchase | ₹ 16,10,000 |
| Brokerage @1% | ₹ 16,100 |
| Cost including brokerage | ₹ 16,26,100 |

6. **Right Shares**

| | |
|---|---|
| No of Right Shares Issued | (8,000+7,000+6,000)/7 = 3,000 shares |
| No of right shares sold | 3,000 shares x 30% = 900 shares |
| Proceeds from sale of right shares to be credited to statement of profit & loss | 900 shares x ₹ 75 = ₹ 67,500 |
| No of right shares subscribed | 3,000-900 = 2,100 shares |
| Amount of right shares subscribed | 2,100 x 230 = ₹ 4,83,000 |

7. **Computation of Dividend Received on 16 Sept 2020**

| | |
|---|---|
| No of shares held during the period of dividend | 8,000 shares |
| Dividend per share | ₹ 6 |
| Dividend Amount | 8,000 x 6 = ₹ 48,000 |
| No of shares received after the period of dividend (excluding bonus & right shares) | 7,000 shares |
| Dividend per share | ₹ 6 |
| Dividend Amount | 7,000 x 6 = ₹ 42,000 |

The amount of dividend for the period for which the shares were not held by the investor has been treated as capital receipt. Thus ₹ 42,000 shall be treated as capital receipt.

8. **Sale Proceeds for the shares sold on 1st Dec. 2020**

| | |
|---|---|
| No of shares sold | 7,000 Shares |
| Sale price per share | ₹ 260 |
| Proceeds from sale of share | 7,000 x 260 = ₹ 18,20,000 |
| Less: Brokerage @ 1% | ₹ 18,200 |
| Net Sale Proceeds | ₹ 18,01,800 |

**9. Profit on sale of shares on 1st Dec. 2020**

| | |
|---|---|
| Sales Proceeds | ₹ 18,01,800 |
| Average Cost | (15,20,000+16,26,100+4,83,000-42,000)/23,100x7000 |
| | = ₹ 10,87,000 |
| Profit on sale of shares | Sales Proceeds – Average Cost |
| | = ₹ 18,01,800-10,87,000<br>= ₹ 7,14,800 |

**10. Computation of Amount of Interim Dividend**

| | |
|---|---|
| No of shares held | 8,000+7,000+6,000+2,100-7,000 |
| | = 16,100 |
| Dividend per share | ₹ 3 per share |
| Dividend Received | 16,100 shares x ₹ 3 per share |
| | = ₹ 48,300 |

**11. Valuation of Shares as on 31 March 2021**

| | |
|---|---|
| Cost of Shares | (15,20,000 + 16,26,100 + 4,83,000 – 42,000) / 23,100 x 16,100 |
| | = 25,00,100 |
| Market Value of Shares | ₹ 260 x 16,100 = ₹ 41,86,000 |
| Closing stock of equity shares has been value at ₹ 25,00,100 i.e. cost being lower than its market value. | |

**II. Profit & Loss Account (Extract)**
**For the period 01 April 2020 to 31 March 2021**

| Particulars | Amount (₹) | Particulars | Amount (₹) |
|---|---|---|---|
| To Balance c/d | 12,70,600 | By Investment in 8% Corporate Bonds Account (Profit on sale of bonds) | 1,76,000 |
| | | By Investment in 8% Corporate Bonds Account (Interest on bonds) | 2,16,000 |
| | | By Sale of Right Shares | 67,500 |
| | | By Investment in Equity Shares of G Ltd (Profit on sale of shares) | 7,14,800 |
| | | By Investment in Equity Shares of G Ltd (Dividend Income) | 96,300 |

III. As per AS 13, when investments are classified from Current Investments to Long term Investments, transfer is made at Cost and Fair value, whichever is less (as on the date of transfer). So, in the given case valuation shall be done as follows:

Date of reclassification/transfer – 15 May 2021
Per Unit Cost of 16,100 shares held – ₹ 25,00,100/16,100 shares – ₹ 155.29 Market Price/Fair Value per share – ₹ 180
As the cost per unit is lower than its fair value, the shares are to be transferred at its cost i.e., at ₹ 155.29 per share on 15 May 2021

**Note:**

1. In the eight last line of the Question, investment in equity shares of G Ltd. was wrongly printed as Z Ltd. in the Question paper. In the above solution, it has been considered as investment in G Ltd. If considered as Investment in equity shares in Z Ltd. (some other investment and not investment in G Ltd.), then the cost of the investment for shares in Z Ltd. will not be available.
2. The entire amount of sale proceeds from rights has been credited to Profit and Loss account in the above solution. However, the sale proceeds of rights in respect of 7,000 shares (purchased cum right on 1.5.20) can be applied to reduce the carrying amount of such investments (without crediting it to profit and loss account) considering that the value of these shares has reduced after becoming their ex -right. In that case, ₹ 22,500 (67,500X 7/21) will be applied to reduce the carrying amount of investment and ₹ 45,000 will be credited to profit and loss account.

## Multiple Choice Questions (MCQs)

**1. The cost of Right shares is *(SM)***

(a) added to the cost of investments. (b) subtracted from the cost of investments.
(c) no treatment is required. (d) added to cost of investments at market value

**Ans: (a)**

**2. Long term investments are carried at *(SM)***

(a) fair value. (b) cost less 'other than temporary' decline.
(c) Cost and market value whichever is less. (d) Cost and market value whichever is higher.

**Ans: (b)**

**3. Current investments are carried at *(SM)***

(a) Fair value. (b) cost.
(c) Cost and fair value, whichever is less. (d) Cost and fair value, whichever is higher

**Ans: (c)**

**4. A Ltd. acquired 2,000 equity shares of Omega Ltd. on cum-right basis at ₹ 75 per share. Subsequently, omega Ltd. made a right issue of 1:1 at ₹ 60 per share, which was subscribed for by A. Total cost of investments at the year- end will be ₹ *(SM)***

(a) 2,70,000. (b) 1,50,000.
(c) 1,20,000. (d) 1,70,000.

**Ans: (a)**

**5. Cost of investment includes *(SM)***

(a) Purchase costs. (b) Brokerage and Stamp duty paid.
(c) Both (a) and (b). (d) none of the above.

**Ans: (c)**



**6. Cost of current investment acquired was ₹ 1,00,000 but the fair value was ₹ 80,000. The Investment was recorded at ₹ 80,000. Now the fair value of Investment is Rs 1,20,000. At what value should it be recorded and how much gain will be credited to profit and loss account. *(MTP 2 Marks July'24)***

(a) No change is required, and it will continue at ₹ 80,000
(b) Current investment will be recorded at ₹ 1,00,000 and gain of ₹ 20,000 will be credited to profit and loss account.
(c) Current investment will be recorded at ₹ 1,20,000 and gain of ₹ 40,000 will be credited to profit and loss account.
(d) Current investment will be recorded at ₹ 1,20,000 but no gain will be credited to profit and loss account.

**Ans (b)**

**7. Securities held as stock-in-trade held by an entity are: (Chapter 5.3 AS 13-Accounting for Investments) *(MTP 2 Marks Aug'24)***

(a) Investments (b) Not Investments
(c) May or may not be Investments (d) Not an asset for entity

**Ans: (b)**

**8. Pratham and Associates is a manufacturer of steel rods. It invests its profits by purchasing shares of listed companies in order to earn dividend income. It had purchased shares of Bharti Airtel Limited in FY 2018-19. However, it sold all the shares of Bharti Airtel Limited during the current year i.e. FY 2023-24. What amount would be disclosed in the profit and loss account for FY 2023-24? *(MTP 2 Marks Apr'24)***

(a) This transaction would not affect the profit and loss account since the primary business of the company is manufacturing, and not investment.
(b) The carrying amount net of expenses would be disclosed in the profit and loss account.
(c) The disposal proceeds net of expenses would be disclosed in the profit and loss account.
(d) The difference between the carrying amount and the disposal proceeds, net of expenses, would be disclosed in the profit and loss account.

**Ans: (d)**

**9. Cost of current investment acquired was ₹ 1000 but the fair value was ₹ 800. The Investment was recorded at ₹ 800. Now the fair value of Investment is Rs 1200. At what value should it be recorded and how much gain will be credited to profit and loss account.** ***(2 Marks MTP Nov'24)***

(a) No change is required and it will continue at ₹ 800

(b) Current investment will be recorded at ₹ 1000 and gain of ₹ 200 will be credited to profit and loss account.

(c) Current investment will be recorded at ₹ 1200 and gain of ₹ 400 will be credited to profit and loss account.

(d) Current investment will be recorded at ₹ 1200 but no gain will be credited to profit and loss account.

**Ans: (b)**

B

# CHAPTER 5.4: AS 16 BORROWING COSTS

| CONCEPTS OF THIS CHAPTER | LDR Questions |
|---|---|
| • Borrowing Costs<br>• Qualifying Asset<br>• Specific Borrowings<br>• Accounting Treatment for Borrowings<br>• Suspension and Cessation of Capitalization.<br>• General Borrowings<br>• Commencement of Capitalization<br>• Disclosure Requirements | LDR<br>LDR Questions<br>Q 17<br>Q 19 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Borrowing Costs

| | | |
|---|---|---|
| **Directly related* for** | Qualifying Assets | Capitalized |
| • Acquisition / Construction / production of | Assets other than Qualifying assets | Revenue Expenditure |

### Qualifying Asset

**An asset when acquired for its intended use or sale**

| Necessarily takes a substantial period of time to get ready for its intended use or sale | Is ready for use |
|---|---|
| Qualifying asset | Not qualifying asset |
| • Manufacturing plants<br>• Power generation facilities<br>• Investment<br>• property<br>• Inventories that require a substantial period of time to bring them to a saleable condition | Other investment and those inventory that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time |

### Borrowing Costs may include

| | |
|---|---|
| Interest & commitment charge on Borrowings | Amortisation of ancillary costs relating to Borrowings |
| Exchange Differences | Amortisation of Discount / Premium on Borrowings |

Finance charges for assets acquired on Finance Lease

### Types of Borrowings

| | | |
|---|---|---|
| Specific borrowings | Borrowed funds specifically for the purpose of obtaining a particular qualifying asset. Borrowing costs that directly relate to that qualifying asset can be readily identified | |
| | If funds temporarily invested | Capitalised borrowing costs= borrowing costs less any income earned on the temporary investment of those borrowings |
| General borrowings | No Direct relationship between particular borrowings and a qualifying asset | |
| | Amount of borrowing costs eligible for capitalisation determined by applying a capitalisation rate to the expenditure on that asset. | The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. |
| | The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period. | |

### Commencement of Capitalization

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied

- Expenditure for the acquisition, construction or production of a qualifying asset is being incurred:
- Borrowing costs are being incurred
- Activities that are necessary to prepare the asset for its intended use or sale are in progress

**Cessation of Capitalisation**

- Capitalization of borrowing costs stops when nearly all activities required to prepare the asset for use or sale are complete.
- An asset is considered ready when its physical construction is finished, even if minor tasks like decoration remain.
- If a qualifying asset is completed in parts and a finished part can be used while construction continues, capitalization for that part ceases when it is ready for use or sale.

**Disclosure**

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

## Question & Answers

### Question 1

**In May, 2020, Omega Ltd. took a bank loan from a Bank. This loan was to be used specifically for the construction of a new factory building. The construction was completed in January, 2021 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was ₹ 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31 st March, 2021 amounted to ₹ 25 lakhs. the company wants to treat ₹ 25 lakhs as part of the cost of factory building and thus capitalize it on the plea that the loan was specifically taken for the construction of factory building? Explain the treatment in line with the provisions of AS 16.** ***(RTP Nov 21, Nov 19, May'18)***

**Answer 1**

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed. Therefore, interest on the amount that has been used for the construction of the building up to the date of completion (January, 2021) i.e. ₹ 18 lakhs alone can be capitalized. It cannot be extended to ₹ 25 lakhs.

### Question 2

**Raj & Co. has taken a loan of US$ 20,000 at the beginning of the financial year for a specific project at an interest rate of 6% per annum, payable annually. On the day of taking loan, the exchange rate between currencies was ₹ 48 per 1 US$. The exchange rate at the closing of the financial year was ₹ 50 per 1 US$. The corresponding amount could have been borrowed by the company in Indian Rupee at an interest rate of 11% per annum. Determine the treatment of borrowing cost in the books of accounts.** ***(RTP Nov '23)***

**Answer 2**

Interest on Foreign Currency Loan:
= US $ 20,000 x₹ 50 per US $ x 6% = ₹ 60,000.
Foreign Exchange Loss on Foreign currency loan:
= US$ 20,000 x₹ (50-48) = ₹ 40,000.
Interest that would have been if the loan was taken in Indian currency i.e. local currency:
= US $ 20,000 x 48 x 11% = ₹1,05,600
Difference between interest on local currency borrowing and foreign currency borrowing:
= ₹ 1,05,600 - ₹ 60,000 = ₹45,600
The entire exchange difference of 40,000 would be considered as borrowing costs. The total borrowing cost would be ₹ 100000 (₹ 60000+ ₹ 40000).

### Question 3

**When should capitalization of borrowing cost cease as per Accounting Standard 16? Explain in brief.** ***(RTP May '21, Nov'20, SM)***

**Answer 3**

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

## Question 4

**(a) An enterprise has constructed a complex piece of equipment (qualifying asset) that is to be installed on the production line of a manufacturing plant. The equipment has been constructed over a period of 15 months. However, on installation, certain calibrations are required to achieve the desired level of production before it is finally commissioned. This process is expected to take approximately 2 months during which test runs will be made. Should the borrowing costs attributable to borrowings pertaining to the 2 months test run period be capitalized?**

**(b) Should capitalization of borrowing costs be continued when the qualifying asset has been constructed but marketing activities to sell the asset are still in progress? *(RTP May '22)***

**Answer 4**

(a) As per AS 16 Borrowing Costs "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". On installation of the equipment, an evaluation has to be made to conclude whether substantially all the activities necessary to prepare the asset are complete. After an equipment has been installed it is usually tested and adjusted for commercial production before it is finally commissioned. The calibrations and adjustments required during this period are performed in order to bring the equipment up to the stage at which it is ready to commence commercial production. Until the asset reaches the stage when it is ready to support commercial levels of production, it is not appropriate to conclude that substantially all the activities necessary to prepare the asset are complete. Thus, the borrowing cost incurred during the normal period of test runs (after the installation) are required to be capitalized.

(b) As per provisions of AS 16, 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. Further, the standard also explains that "An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might sill continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete". The emphasis in the Standard is on "to prepare the qualifying asset for its intended use or sale" and not the actual activity of sale. Therefore, where the physical construction of the asset is complete, substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Therefore, in the given case, the borrowing costs pertaining to the period during which the marketing activities to sell the asset are still in progress should not be capitalized as part of the cost of the asset.

## Question 5

**A company incorporated in June 2023, has setup a factory within a period of 8 months with borrowed funds. The construction period of the assets had reduced drastically due to usage of technical innovations by the company and the company is able to justify the reasons for the same. Whether interest on borrowings for the period prior to the date of setting up the factory should be capitalized although it has taken less than 12 months for the assets to get ready for use. You are required to comment on the necessary treatment with reference to AS 16. *(MTP 5 Marks April 21, April 22, RTP Nov'18, MTP 4 Marks Aug'24*)**

**Answer 5**

As per AS 16 'Borrowing Costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Further, the standard states that what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered. It may be implied that there is a rebuttable presumption that a 12 months period constitutes substantial period of time. Under present circumstances where construction period has reduced drastically due to technical innovation, the 12 months period should at best be looked at as a benchmark and not as a conclusive yardstick. It may so happen that an asset under normal circumstances may take more than 12 months to complete. However, an enterprise that completes the asset in 8 months should not be penalized for its efficiency by denying it interest capitalization and vice versa. The substantial period criteria ensures that enterprises do not spend a lot of time and effort capturing immaterial interest cost for purposes of capitalization. Therefore, if the factory is constructed in 8 months then it shall be considered as a qualifying asset. The interest on borrowings for the same shall be capitalised although it has taken less than 12 months for the asset to get ready to use.

## Question 6

**ABC Limited has started construction of an asset on 1st December, 2021, which continues till 31st March, 2022 (and is expected to go beyond a year). The entity has not taken any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. The directly attributable expenditure at the beginning of the month on this asset was ₹ 10 lakh in December 2021 and ₹ 4 lakh in each of the months of January to March 2022. At the beginning of the year, the entity had taken Inter Corporate Deposits of ₹ 20 lakh at 9% rate of interest and had an overdraft of ₹ 4 lakh, which increased to ₹ 8 lakh on 1st March, 2022. Interest was paid on the overdraft at 10% until 1st January, 2022 and then the rate was increased to 12%. You are required to calculate the annual capitalization rate for computation of borrowing cost in accordance with AS 16 'Borrowing Costs'.** ***(MTP 5 Marks Nov'21 & April 23)***

**Answer 6**

**Calculation of capitalization rate on borrowings other than specific borrowings**

| Nature of general borrowings | Period of Outstanding balance | Amount of loan(Rs.) | Rate of interest p.a. | Weighted average amount of Interest (Rs.) |
|---|---|---|---|---|
| | a | b | c | d=[bXc)X(a/12)] |
| 9% Debentures | 12 months | 20,00,000 | 9% | 1,80,000 |
| Bank overdraft | 9 months | 4,00,000 | 10% | 30,000 |
| | 2 months | 4,00,000 | 12% | 8,000 |
| | 1 month | 8,00,000 | 12% | 8,000 |
| | | 36,00,000 | | 2,26,000 |

Weighted average cost of borrowings

=(20,00,000 x(12/12))+(4,00,000 x(11/12))+(8,00,000 x (1/12)} = 24,33,334

Capitalisation rate = [(Weighted average amount of interest / Weighted average of general borrowings) x 100]

= [(2,26,000 / 24,33,334) x 100] = 9.29% p.a.

## Question 7

**Omega Limited has borrowed a sum of US $ 10,00,000 at the beginning of Financial Year 2021-22 for its residential project at 4%. The interest is payable at the end of the Financial Year. At the time of availment of loan exchange rate was ₹ 56 per US $ and the rate as on 31st March, 2022 was ₹ 62 per US $. If Omega Limited had borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%.**

**You are required to compute Borrowing Cost and exchange difference for the year ending 31st March, 2022 as per applicable Accounting Standards.** ***(MTP 5 Marks Sep'22,Mar'18, Mar'19, MTP 4 Marks March 21 & Oct '23, RTP May '21)***

**Answer 7**

(i) Interest for the period 2021-22

= US $ 10 lakhs x 4% × ₹ 62 per US$ = ₹ 24.80 lakhs

(ii) Increase in the liability towards the principal amount

= US $ 10 lakhs × ₹ (62 - 56) = ₹ 60 lakhs

(iii) Interest that would have resulted if the loan was taken in Indian currency
= US $ 10 lakhs × ₹ 56 x 10.5% = ₹ 58.80 lakhs

(iv) 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 and the remaining ₹ 26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11.

## Question 8

**Vital Limited borrowed an amount of ₹150 crores on 1.4.2021 for construction of boiler plant @ 10% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Vital Ltd. capitalized ₹ 19.50 crores for the accounting period ending on 31.3.2022. Due to surplus fund out of ₹150 crores, an income of ₹ 1.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard. *(MTP 5 Marks March '23, RTP Nov 20)(Same concepts different figures SM)***

**Answer 8**

Para 10 of AS 16 'Borrowing Costs' states that to the extent the funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings. The capitalization rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. Hence, in the above case, treatment of accountant of Vital Ltd. is incorrect. The amount of borrowing costs capitalized for the financial year 2021-22 should be calculated as follows:

| | |
|---|---|
| Actual interest for 2021-22 (10% of ₹ 150 crores) | ₹ 15.00 crores |
| Less: Income on temporary investment from specific borrowings | (₹ 1.50 crores) |
| Borrowing costs to be capitalized during year 2021-22 | ₹ 13.50 crores |

## Question 9

**How will interest be capitalized when qualifying assets are funded by borrowings in the nature of bonds that are issued at a discount?**

**Vivtsu Ltd. issued in year 1, a 3 year 10% p.a. (interest paid annually) bond with a face value of ₹ 1,00,000 at a price of ₹ 90,000 to finance a qualifying asset which is ready for intended use at the end of year 2. Compute the amount of borrowings costs to be capitalized if the company uses for amortization of discount straight line basis. *(RTP Jan'25)***

**Answer 9**

As per AS 16, "Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds". Further, as per para 4 (b) of the standard, "amortization of discounts or premiums relating to borrowings" as a component of borrowing costs. Thus, the borrowing costs comprise the periodic interest payable on the bonds in question and the amount of discount amortised during the period.

Paragraph 6 of the Statement, inter-alia, states that "Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset".

Further, paragraph 19 states that "Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete". Thus, only that portion of the amortised discount should be capitalised as part of the cost of a qualifying asset which relates to the period during which acquisition, construction or production of the asset takes place.

**Straight line basis**

(Amount in ₹)

| Years | Interest | Amortisation of discount | Total borrowing costs |
|---|---|---|---|
| Year 1 | 10,000 | 3,333 | 13,333 |
| Year 2 | 10,000 | 3,333 | 13,333 |
| Year 3 | 10,000 | 3,334 | 13,334 |

In the above case, the amount of borrowing costs capitalized would be ₹ 13,333 in Year 1 and Year 2. The borrowing costs of ₹ 13,334 incurred in Year 3 would be expensed since the asset is ready for its intended use at the end of Year 2.

## Question 10

**U Limited has obtained a term loan of ₹ 620 lacs for a complete renovation and modernization of its Factory on 1st April, 2020. Plant and Machinery was acquired under the modernization scheme and installation was completed on 30th April, 2021. An expenditure of ₹ 564 lacs was incurred on this Plant and Machinery and the balance loan of ₹ 56 lacs has been used for working capital purposes. The company has paid total interest of ₹ 68.20 lacs during financial year 2020-2021 on the above loan. The accountant seeks your advice how to account for the interest paid in the books of accounts. Will your answer be different, if the whole process of renovation and modernization gets completed by 28th February 2021? *(MTP 5 Marks, Oct '21)***

**Answer 10**

Borrowing Cost: As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred. Borrowing costs should be expensed except where they are directly attributable to acquisition, construction or production of qualifying asset.

Qualifying Asset: A qualifying asset is an asset that necessarily takes a substantial period of time (ordinarily, a period of twelve months unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case) to get ready for its intended use or sale.

**(i) When construction of asset completed on 30th April, 2021**

The treatment for total borrowing cost of ₹ 68.20 lakhs will be as follows:

| Purpose | Nature | Interest to be capitalized ₹ in lakhs | Interest to be charged to profit and loss account ₹ in lakhs |
|---|---|---|---|
| Plant and machinery | Qualifying asset | [68.20 x (564/620)] | |
| Under | | = 62.04 | |
| Modernization | | | |
| And renovation | | | |
| scheme | Not a qualifying | | [68.20 x (56/620)] |
| Working Capital | asset | | = 6.16 |
| | | 62.04 | 6.16 |

**(ii) When construction of assets is completed by 28th February, 2019**

In this scenario, when the process of renovation gets completed in less than 12 months, the plant and machinery will not be considered as qualifying assets (until and unless the entity specifically considers that the asset took substantial period of time for completing their construction) and the whole of interest will be required to be charged off / expensed off to Profit and loss account.

## Question 11

**Loyal Ltd. has undertaken a project for expansion of capacity as per the following details:**

| | Plan (₹) | Actual (₹) |
|---|---|---|
| October, 2023 | 5,00,000 | 4,00,000 |
| November, 2023 | 6,50,000 | 7,95,000 |
| December, 2023 | 20,00,000 | - |
| January, 2024 | 2,00,000 | 50,000 |

| | | |
|---|---|---|
| February, 2024 | 9,00,000 | 2,00,000 |
| March, 2024 | 10,00,000 | 12,00,000 |

**The company pays to its bank interest at a rate of 15% p.a., which is debited on a monthly basis. During the half year, company had ₹ 20 lakh overdraft up to 31st December, surplus cash in January and again overdraft of ₹ 14 lakh from 1.2.2024 and ₹ 30 lakh from 1.3.2024. The company had a strike during December and hence could not continue the work during said period. However, the substantial administrative work related to the project was continued. Onsite work was again commenced on 1st January and all the work were completed on 31st March. Assume that expenditure was incurred on 1st day of each month.**

**Calculate interest to be capitalized giving reason wherever necessary. Assume overdraft will be less, if there is no capital expenditure.** ***(RTP Sep'24)***

**Answer 11**

**Loyal Ltd.**

| Month | Actual Expenditure (₹) | Interest on outstanding amount @ 15% p.a. | Interest capitalized (₹) | Outstanding amount | Cumulative amount (₹) |
|---|---|---|---|---|---|
| | 1 | | 2 | 3 | |
| October, 2023 | 4,00,000 | 4,00,000*15% *1/12 | 5,000 | 4,05,000 | 4,05,000 |
| November, 2023 | 7,95,000 | (4,05,000+7,95,000) *15%*1/12 | 15,000 | (4,05,000 + 7,95,000 + 15,000) | 12,15,000 |
| December, 2023 | - | (12,15,000) *15%*1/12 | 15,188 | 12,15,000 + 15,188 | 12,30,188 |
| January, 2024 | 50,000 | | - | 12,30,188 + 50,000 | 12,80,188 |
| February, 2024 | 2,00,000 | 14,00,000 *15%*1/12 | 17,500 | 12,80,188 + 2,00,000 + 17,500 | 14,97,688 |
| March, 2024 | <u>12,00,000</u> | (14,97,688 + 12,00,000)*15 %*1/12 | <u>33,721</u> | 14,97,688 + 12,00,000 + 33,721 | 27,31,409 |
| | <u>26,45,000</u> | | <u>86,409</u> | | |

**Note:**

1. As per para 18 of AS 16, 'Borrowing Cost', capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Therefore, the interest for that period i.e. for the month of December has also been capitalized.
2. During January, the company did not incur any interest as there was surplus cash in January. Therefore, no amount should be capitalized during January as per para 14(b) of AS 16.
3. During February, actual overdraft (borrowings) was ₹ 14 lakh only. Hence, interest of ₹ 17,500 on ₹ 14,00,000 has been calculated even though actual expenditure on project exceed ₹ 14 lakh.

## Question 12

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

**Following is the detail of the work done on different phases of the building during the current year:**

**(₹ in lakhs)**

| | Phase I | Phase II | Phase III | Phase IV |
|---|---|---|---|---|
| | ₹ | ₹ | ₹ | ₹ |
| Cash expenditure | 10 | 30 | 25 | 30 |
| Building purchased | 24 | 34 | 30 | 38 |
| expenditure | | | | |
| Total expenditure of all phases | | | | 221 |

| | | | | |
|---|---|---|---|---|
| Loan taken @ 15% at the beginning of the year | | | | 200 |

**During mid of the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year.** ***(RTP Nov '22, SM)***

**Answer 12**

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

**Accounting treatment:**

1. **For Phase I and Phase II**

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

2. **For Phase III and Phase IV**

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

## Question 13

**On 15th April, 2019 WIVITZU Ltd. obtained a Term Loan from the Bank for ₹ 320 lakhs to be utilized as under:**

| | ₹ (in lakhs) |
|---|---|
| Construction for factory shed | 240 |
| Purchase of Machinery | 30 |
| Working capital | 24 |
| Purchase of Vehicles | 12 |
| Advance for tools/cranes etc. | 8 |
| Purchase of technical know how | 6 |

**In March, 2020 construction of shed was completed and machinery was installed. Total interest charged by the bank for the year ending 31st March, 2020 was ₹ 40 lakhs.**

**In the context of provisions of AS 16 'Borrowing Costs', show the treatment of interest and also explain the nature of Assets.** ***(PYP 5 Marks Nov '20)(MTP 5 Marks Sep '23)***

**Answer 13**

As per AS 16 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred. Construction of factory shed amounting ₹ 240 lakhs is qualifying asset in the given case. The interest for this amount during the year will be added to the cost of factory shed. All others (purchase of machinery, vehicles and technical know how, working capital, advance for tools/cranes) are non-qualifying assets and related borrowing cost will be charged to Profit and Loss statement. Qualifying Asset as per AS 16 (construction of a shed) = ₹ 240 lakhs Borrowing cost to be capitalized = ₹ 40 lakhs x 240/320 = ₹

30 lakhs Interest to be debited to Profit or Loss account: ₹ (40 – 30) = ₹ 10 lakhs. Note: Assumed that construction of factory shed completed on 31st March 2020.

## Question 14

**H Ltd. began the construction of a new building on 1st April 2022. It obtained a special loan of ₹ 6,00,000 on 1st April 2022 at an interest of 12% to finance the construction of the building.**

**The company's other outstanding two non-specific loans on 1st April, 2022 were as follows:**

| Amount in ₹ | Rate of Interest |
|---|---|
| 30,00,000 | 14% |
| 54,00,000 | 16% |

**The expenditure incurred on the building project was as per detail given below:**

| | Amount in ₹ |
|---|---|
| 1st May, 2022 | 12,00,000 |
| 1st July, 2022 | 15,00,000 |
| 1st October, 2022 | 27,00,000 |
| 1st March, 2023 | 7,20,000 |

**The building was completed by 31st March 2023.**

**Following the provisions of Accounting Standard 16, you are required to calculate the amount of interest to be capitalized and also give one Journal Entry for capitalizing the cost and borrowing cost in respect of the building. *(RTP May'24)(Same Concept Different figure PYP May '19, 5 Marks)***

**Answer 14**

**Interest amount to be capitalized**

| | | ₹ |
|---|---|---|
| Specific borrowings (₹ 6,00,000 x 12%) | = | 72,000 |
| Non-specific borrowings [₹ 30,35,000 (₹ 36,35,000 – ₹ 6,00,000) x 15.29%*] | = | 4,64,052 |
| Amount of interest to be capitalized | = | 5,36,052 |

**Journal Entry for capitalizing cost and borrowing cost**

| Date | Particulars | | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| 31.3.2023 | Building account (Cost of building ₹ 61,20,000 + borrowing cost ₹ 5,36,052) | Dr. | 66,56,052 | |
| | To Bank account | | | 66,56,052 |
| | (Being amount of cost of building and borrowing cost thereon capitalized) | | | |

**Working notes:**

**(i) Computation of average accumulated expenses**

| | | ₹ |
|---|---|---|
| ₹ 1 2 ,00,000 x 11 / 12 | = | 11,00,000 |
| ₹ 15,00,000 x 9 / 12 | = | 11,25,000 |
| ₹ 27,00,000 x 6 / 12 | = | 13,50,000 |
| ₹ 7,20,000 x 1 / 12 | = | 60,000 |
| 61,20,000 | | 36,35,000 |

**(ii) Calculation of average interest rate other than for specific borrowings**

| Amount of loan (₹) | Rate of interest | | Amount of interest (₹) |
|---|---|---|---|
| 30,00,000 | 14% | = | 4,20,000 |
| 54,00,000 | 16% | = | 8,64,000 |
| 84,00,000 | | | 12,84,000 |
| Weighted average rate of interest ($\frac{12,84,000}{84,00,000}$ $X$ 100 ) | | = | 15.29%* (Rounded off) |

## Question 15

**Glen Ltd. began construction of a new building on 1st January, 2022. On 1st April, 2022, following two loans were obtained to fund the construction cost:**

(i) **Loan of ₹ 60,00,000 from Data Bank Ltd. was taken at interest rate of 8% per annum. This loan was fully utilized for construction of the new building.**

(ii) **Loan of ₹ 20,00,000 from Satya Bank Ltd. Out of this, loan amount of ₹ 6,00,000 was utilized for working capital purpose. Total interest of ₹ 1,92,000 were paid to Satya Bank Ltd. for the financial year 2022-23.**

**Construction of the new building was completed on 31st January, 2023 and was ready for its intended use on the same date.**

**None of the loan was repaid during the year. The building is a qualifying asset for the purpose of AS-16.**

**Out of loan from Data Bank Ltd., surplus funds were temporarily invested for the short period of time. This temporary investment earned interest of ₹ 30,000.**

**You are required to calculate the amount of interest (a) to be capitalized, (b) to be charged to profit and loss account from the total interest incurred as borrowing cost during the year 2022-23 (as per AS-16).** ***(PYP 5 Marks Nov'23)***

**Answer 15**

According to AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognized as an expense in the period in which they are incurred.

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

Thus, eligible borrowing cost on Loan of data bank to be capitalized:

= ₹(60,00,000 x 8%)x 10/12 - ₹ 30,000

= ₹4,00,000 - ₹ 30,000 = ₹3,70,000

| Loan | Particulars | Nature of assets | (a) Interest to be Capitalized (₹) | (b) Interest to be charged to Profit & Loss Account (₹) |
|---|---|---|---|---|
| Data bank | Construction of factory building | Qualifying Asset | 3,70,000 | (4,80,000 - 4,00,000) 80,000 |
| Satya Bank | Construction of factory building | Qualifying Asset | (1,92,000x14/20) x 10/12 = 1,12,000 | (1,92,000 x 14/20) x 2/12 = 22,400 |
| Satya Bank | Working Capital | Not a Qualifying Asset | NIL | (1,92,000x6/20) = ₹57,600 |
| | Total | | ₹4,82,000 | ₹1,60,000 |

**Note:** Loan from Satya bank is considered to be specific borrowings.

**EXAM INSIGHTS:** Majority of the examinees were not able to calculate the amount of interest to be capitalized and charged to the profit and loss account.

## Question 16

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

| Intended Purpose | Amount ₹ in lakhs |
|---|---|
| Construction of factory building | 40 |
| Working Capital | 30 |
| Purchase of Machinery | 15 |
| Purchase of Furniture | 2 |
| Purchase of truck | 13 |

**Additional Information:**

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

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

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

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

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

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

**You are required to show the treatment of interest as per AS 16 in respect of borrowing cost for the year ended 31st March, 2022 in the Books of Expert Limited.** ***(RTP May 23) (Same concept different figures MTP 5 Marks Oct '22, MTP Oct. '18, MTP Aug. '18, MTP Oct. '19, 5 Marks, RTP May 20)***

**Answer 16**

According to AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use. As per the Standard, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount o f borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognized as an expense in the period in which they are incurred. It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

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

| **Particulars** | **Nature of assets** | **Interest to be capitalized (₹)** | **Interest to be charged to Profit & Loss Account (₹)** |
|---|---|---|---|
| Construction of factory | Qualifying Asset | 9,50,000x40/100 | NIL |
| building | | = ₹ 3,80,000 | |
| Purchase of Machinery | Not a Qualifying Asset | NIL | 9,50,000x15/100 |
| | | | = 1,42,500 |
| Purchase of and | Not a Qualifying Asset | NIL | 9,50,000x2/100 |
| furniture | | | =19,000 |
| Purchase of truck | Not a Qualifying Asset | NIL | 9,50,000x13/100 |
| | | | = 1,23,500 |
| Working Capital | Not a Qualifying Asset | NIL | 9,50,000x30/100 |
| | | | = ₹ 2,85,000 |
| Total | | ₹ 3,80,000 | ₹ 5,70,000 |

## Question 17

LDR

**Zebra Limited began construction of a new plant on 1st April,2021 and obtained a special loan of ₹ 20,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.**

**The expenditure that was incurred on the construction of plant was as follows:**

| | ₹ |
|---|---|
| 1st April,2021 | 10,00,000 |
| 1st August,2021 | 24,00,000 |
| 1st January,2022 | 4,00,000 |

**The company's other outstanding non-specific loan was ₹ 46,00,000 at an interest rate of 12%.**

**The construction of the plant completed on 31st March,2022. You are required to:**

(a) **Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".**

(b) **Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.** ***(PYP 5 Marks May'22)***

**Answer 17**

Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

| | ₹ |
|---|---|
| Cost of Plant (10,00,000 + 24,00,000 + 4,00,000) | 38,00,000 |
| Add: Amount of interest to be capitalized (W.N.) | 3,24,000 |
| | 41,24,000 |

**Journal Entry**

| | | | ₹ | ₹ |
|---|---|---|---|---|
| 31st March, 2022 | Plant A/c | Dr. | 41,24,000 | |
| | To Bank A/c | | | |
| | [Being amount of cost of plant and borrowing cost thereon capitalized] | | | 41,24,000 |

**Working Note:**

**Computation of interest to be capitalized:**

| | Expenditure | | | ₹ |
|---|---|---|---|---|
| 1st April, 2021 | 10,00,000 | On specific borrowing | ₹ 10,00,000 x 10% | 1,00,000 |
| 1st August, 2021 | 24,00,000 | On specific borrowing | ₹ 10,00,000 x 10% | 1,00,000 |
| 1st August, 2021 | | On non-specific borrowings | ₹ 14,00,000 $\times \frac{8}{12}$ x 12% | 1,12,000 |
| 1st January, 2022 | 4,00,000 | On non-specific borrowings | ₹ 4,00,000 $\times \frac{3}{12} \times$ 12 % | 12,000 |
| | | | | **3,24,000** |

Alternatively, interest cost to be capitalized can be derived by computing average accumulated expenses in the following manner.

**Computation of Average Accumulated Expenses:**

| | | |
|---|---|---|
| 1st April, 2021 | 10,00,000 x 12/12 | 10,00,000 |
| 1st August, 2021 | 10,00,000 x 12/12<br>14,00,000 x 8/12 | 10,00,000<br>9,33,333 |
| 1st January, 2022 | 4,00,000 x 3/12 | 1,00,000 |
| | | 30,33,333 |

Computation of interest to be capitalized:

| | | ₹ |
|---|---|---|
| On specific borrowing | ₹ 20,00,000 x 10% | 2,00,000 |
| On non-specific borrowing | ₹ (30,33,333- 20,00,000) x 12% | 1,24,000 |
| | | 3,24,000 |

**NOTE**: Since specific borrowings are earmarked for construction of a particular qualifying asset, it cannot be used for construction of any other qualifying asset except for temporary investment. Therefore, once the commencement of capitalization of borrowing cost criteria are met, actual borrowing cost incurred on specific borrowing shall be capitalized irrespective of the fact that amount had been utilized in parts.

**EXAM INSIGHTS**: Majority of the examinees erred in calculating the amount of interest on non-specific borrowings and hence, they failed to calculate the amount of interest to be capitalized as per the provisions of AS 16, "Borrowing Costs". They were also not able to journal entry for capitalizing the cost and the borrowing cost in respect of plant for the year ended 31st March, 2022.

### Question 18

**On 1st April, 2023, Green Limited started the construction of an Office Building (qualified asset). The land under the building is regarded as a separate asset and is not a part of qualifying asset.**

**For the purpose of construction of building, the company raised a specific loan of ₹ 14 lakhs from a Bank at an interest rate of 12% per annum. An interest income of ₹ 15,000 was earned on this loan while it was held in anticipation of payments.**

The company's other outstanding loans on 1stApril, 2023 were as follows:

| Amount of Loan | Rate of Interest per annum |
|---|---|
| ₹ 20,00,000 | 15% |
| ₹ 30,00,000 | 8% |

The construction of building started on 1stApril, 2023 and was completed on 31st January, 2024 when it was ready for its intended use. Up to the date of completion of the building, the following payments were made to the contractor:

| Payment date | Amount in ₹ |
|---|---|
| 1st April,2023 | 4,00,000 |
| 1st August,2023 | 10,00,000 |
| 1st December,2023 | 25,00,000 |
| 31st January,2024 | 5,00,000 |

to be 20 years and depreciation is calculated on straight line method.

You are required to:

(i) Calculate the amount of borrowing cost to be capitalized.

(ii) Pass initial journal entry to recognise the cost of building.

(iii) Depreciation on building for the year ending 31st March, 2024.

(iv) Carrying value of building as on 31st March, 2024. *(PYP 7 Marks May'24)*

**Answer 18**

**Computation of borrowing cost to be capitalized for specific borrowings and general borrowings based on weighted average accumulated expenses**

| Date of incurrence of expenditure | Amount spent | Financedthrough | Calculation | ₹ |
|---|---|---|---|---|
| 1st April 2023 | 4,00,000 | Specific borrowing | 4,00,000 x 12% x 10/12 | 40,000 |
| 1st August 2023 | 10,00,000 | Specific borrowing | 10,00,000 x 12% x 10/12 | 1,00,000 |
| 1st December 2023 | 25,00,000 | General borrowing | 25,00,000 x 10.8% x 2/12 | 45,000 |
| 31st January2024 | 5,00,000 | General borrowing | 5,00,000 x 10.8% x 0/12 | Nil |
| | | | | 1,85,000 |
| Less: interest income on borrowing | | | | (15,000) |
| Total amount borrowing cost to be capitalized | | | | 1,70,000 |

**(ii) Journal Entry**

| Date | Particulars | | ₹ | ₹ |
|---|---|---|---|---|
| 31.1.2024 | Building account | Dr. | 45,70,000 | |
| | To Bank account | | | 44,00,000 |
| | To Interest payable (borrowing cost) | | | 1,70,000 |
| | (Being expenditure incurred on construction of building and borrowing cost thereon capitalized) | | | |

**Note:** In the above journal entry, it is assumed that interest amount will be paid at the year end. Hence, entry for interest payable hasbeen passed on 31.1.2024.

**Alternatively, following journal entry may be passed if interest is paidon the date of capitalization:**

| Date | Particulars | | ₹ | ₹ |
|---|---|---|---|---|
| 31.1.2024 | Building account | Dr. | 45,70,000 | |
| | To Bank account | | | 45,70,000 |
| | (Being expenditure incurredon construction of building and borrowing cost thereoncapitalized) | | | |

**(iii) Depreciation on building for the year ending 31.3.2024**

Cost of building 45,70,000

Life of building = 20 years

Depreciation = (45,70,000/20) x 2/12 = 38,083.33

(iv) **Carrying Value of Building on 31st March 2024:**

Carrying Value = Cost of Building - Accumulated Depreciation

= 45,70,000- 38,083.33

= 45,31,917

**Working Notes:**

1. **Calculation of capitalization rate on borrowings other thanspecific borrowings**

| Amount of loan (₹) | Rate of interest | | Amount of interest (₹) |
|---|---|---|---|
| 20,00,000 | 15% | = | 3,00,000 |
| 30,00,000 | 8% | = | 2,40,000 |
| 50,00,000 | | | **5,40,000** |
| Weighted average rate of interest $\left(\frac{5,40,000}{50,00,000} \times 100\right)$ | | = | **10.8%*** |

2. **Total expenses to be capitalized for building**

| | ₹ |
|---|---|
| Cost of building ₹(4,00,000 + 10,00,000 + 25,00,000 + 5,00,000) | 44,00,000 |
| Add: Amount of interest to be capitalized | 1,70,000 |
| | 45,70,000 |

**Question 19** LDR

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

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

| | | | |
|---|---|---|---|
| I. | 8% | Debentures | ₹ 15,00,000 |
| II. | 15% | Term Loan | ₹ 30,00,000 |
| III. | 10% | Other Loans | ₹ 18,00,000 |

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

**(i) Building 70,00,000**

**(ii) Furniture ₹ 22,00,000**

**(iii) Plant & Machinery ₹ 90,00,000**

**(iv) Factory Shed ₹ 43,00,000**

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

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

***(PYP 5 Marks May '23)***

**Answer 19**

Interest to be Capitalized (on qualifying asset)

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

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

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

**Working note:**

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

| | Particulars | Qualifying asset | # Computation | Interest-Capitalized | Interest charged to P&L A/c |
|---|---|---|---|---|---|
| i. | Building | Yes | 45,00,000/2,00,00,000 x 63,00,000 x 11.9048% | 1,68,750 | - |
| ii. | Furniture | No | 22,00,000/2,00,00,000 x 63,00,000 x 11.9048% | - | 82,500 |
| iii. | Plant & Machinery | Yes | 90,00,000/2,00,00,000 x 63,00,000 x 11.9048% | 3,37,500 | - |
| iv. | Factory shed | Yes | 43,00,000/2,00,00,000 x 63,00,000 x 11.9048% | 1,61,250 | - |
| | Total | | | 6,67,500 | 82,500 |

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

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

2. Weighted Average interest rate for non-specific borrowings

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

**EXAM INSIGHTS :** Most of the examinees were able to calculate the borrowing cost for both qualifying and non-qualifying assets.

## Multiple Choice Questions (MCQs)

1. **As per AS 16, all the following are qualifying assets except** ***(SM)***
   (a) Manufacturing plants and Power generation facilities
   (b) Inventories that require substantial period of time
   (c) Assets those are ready for sale.
   (d) None of the above

**Ans: (c)**

2. **Which of the following statement is correct:** ***(SM)***
   (a) Entire exchange gain is reduced from the cost of the Qualifying asset.
   (b) Entire exchange loss is added to the cost of a Qualifying asset.
   (c) No adjustment is done for the exchange loss while computing cost of Qualifying asset.

(d) None of the above

**Ans: (c)**

**3. Capitalization rate considers:** ***(SM)***

(a) Borrowing costs on general borrowings only.
(b) Borrowing costs on general and specific borrowings both.
(c) Borrowing costs on specific borrowings only
(d) None of the above

**Ans: (a)**

**4. If the amount eligible for capitalisation in case of inventory as per AS 16 is ₹ 12,000 and cost of inventory is ₹ 40,000 and its net realizable value is ₹ 45,000; What amount can be capitalised as a part of inventory cost.** ***(SM)***

(a) ₹ 12,000.
(b) ₹ 5,000.
(c) ₹ 7,000.
(d) ₹ 10,000.

**Ans: (b)**

**5. Vivtsu Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:**

**i) 15th May, 20X1: Loan interest relating to the project starts to be incurred**
**ii) 2nd June, 20X1: Technical site planning commences**
**iii) 19th June, 20X1: Expenditure on the project started to be incurred**
**iv) 18th July, 20X1: Construction work commences**

**Identify the commencement date for capitalization under AS 16.** ***(SM)***

(a) 15th May, 20X1
(b) 19th June, 20X1
(c) 18th July, 20X1
(d) 2nd June, 20X1

**Ans: (b)**

**6. Gyan Ltd. borrowed ₹ 10 crore for construction of a plant at the rate of 10% per annum (interest paid annually ₹ 1 crore). The construction was being carried on and out of the borrowings, ₹ 4 crore was temporarily placed in a fixed deposit at the rate of 6% per annum (interest earned ₹ 24 lakh). At the end of the year, how much cost of borrowing Gyan Limited will capitalise?** ***(RTP May'24)***

(a) Interest paid on ₹ 10 crore i.e. ₹ 1 crore
(b) Interest paid on ₹ 6 crore as only this amount was utilized i.e. ₹ 60 Lakh.
(c) Interest paid less income on temporary investment i.e. ₹ 76 lakh
(d) Nothing will be capitalized

**Ans: (c)**

**7. Gyan Ltd. borrowed ₹ 10 crore for construction of a plant at the rate of 10% per annum (interest paid annually ₹ 1 crore). The construction was being carried on and out of the borrowings, ₹ 4 crore was temporarily placed in a fixed deposit at the rate of 6% per annum (interest earned ₹ 24 lakh). At the year end, how much cost of borrowing Gyan Limited will capitalise?** ***(MTP 2 Marks July'24)***

(a) Interest paid on ₹10 crore i.e. ₹1 crore
(b) Interest paid on ₹6 crore as only this amount was utilized i.e. ₹60 Lakh.
(c) Interest paid less income on temporary investment i.e. ₹76 lakh
(d) Nothing will be capitalised.

**Ans: (c)**

**8. Vijay Ltd. borrowed ₹ 30 lakh at interest rate of 5% per annum and purchased plant and machinery for ₹ 60 lakh (using borrowed funds) and started production. It took 1 year time for Vijay Ltd. to create optimum market for the goods manufactured and generate revenue. How much borrowing cost can be capitalized by the cost of plant and machinery:** ***(MTP 2 Marks Aug'24)***

(a) ₹ 1.5 lakh
(b) ₹ 3 Lakh
(c) Nil
(d) ₹ 5 Lakh

**Ans: (c)**

B

# CHAPTER 5.5: AS–19 LEASES

**CONCEPTS OF THIS CHAPTER**

- Definition of Lease
- Finance Lease
- Accounting for Lessees
- Sale and Leaseback
- Classification of Leases
- Operating Lease
- Accounting for Lessors
- Disclosures

LDR

**LDR Questions**
**Q 12**
**Q 14**

## QUICK REVIEW OF IMPORTANT CONCEPTS

| Finance leases | Operating leases |
|---|---|
| A lease that transfers substantially, all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred. | A lease is classified as an Operating Lease, if it does not transfer substantially all the risk and rewards incident to ownership. |

**Indicators of Finance Lease**

- Ownership transfers to the lessee by the end of the term.
- The lessee has a purchase option at a price significantly below fair value, making exercise reasonably certain.
- The lease term covers most of the asset's economic life, even without title transfer.
- The present value of lease payments is substantially all of the asset's fair value.
- The asset is highly specialized, usable only by the lessee without major modifications.



### Accounting for Finance Leases

**Books of Lessee**

At lease inception, the lessee records the asset and liability at the lower of:

- Fair value of the leased asset.
- Present value of minimum lease payments (discounted using the implicit interest rate, or if impracticable, the lessee's incremental borrowing rate).

Lease payments are split between finance charges and liability reduction. A finance lease incurs both depreciation and finance expenses. Depreciation follows AS 10 (Revised) and aligns with owned assets. If ownership is uncertain, depreciation is over the lease term or useful life, whichever is shorter. Initial direct costs related to securing the lease are included in the asset's value.

**Books of Lessor**

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

In a finance lease, the lessor recognises the net investment in lease which is usually equal to fair value as receivable by debiting the Lessee A/c.

### Accounting for Operating Leases

**Accounting treatment in the Books of lessee**

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

**Accounting Treatment in the books of Lessor**

- Present the leased asset as fixed assets on its balance sheet.
- Recognize lease income on a straight-line basis over the lease term, unless another method better reflects

the benefit pattern from the leased asset.

- Depreciate the leased asset based on the lessor's usual depreciation policy for similar assets.
- Determine and treat impairment losses according to AS 28*

**Where sale and leaseback results in operating lease**

**Case 1: Sale price = Fair Value** | Profit or loss should be recognized immediately.

**Case 2: Sale Price < Fair Value**

Profit should be recognized immediately, while loss should also be recognized immediately, unless it is compensated by future lease payments below market price. In that case, the loss should be deferred and amortized in proportion to the lease payments over the asset's expected usage period.

**Case 3: Sale Price > Fair Value**

If the sale and leaseback transaction results in a price exceeding the fair value, the excess should be deferred and amortized over the asset's expected usage period. If the fair value is less than the carrying amount, a loss equal to the difference between the carrying amount and fair value should be recognized immediately.

| **Sale price established at fair value** | **Carrying amount equal to fair value** | **Carrying amount less than fair value** | **Carrying amount above fair value** |
|---|---|---|---|
| Profit | No profit | Recognize profit immediately | Not applicable |
| Loss | No loss | Not applicable | Recognize loss Immediately |
| Sale price below fair value (paragraph 50) | | | |
| Profit | No profit | Recognize profit immediately | No profit (note 1) |
| Loss not compensated by future lease payments at below market price | Recognize loss immediately | Recognize loss immediately | (note 1) |
| Loss compensated by future lease payments at below market price | Defer and amortize loss | Defer and amortize loss | (note 1) |
| Sale price above fair value (paragraph 50) | | | |
| Profit | Defer and amortize profit | Defer and amortize profit | Defer and amortize profit (note2) |
| Loss | No loss | No loss | (note 1) |



**Question & Answers**

## Question 1

**What are the disclosures requirements for operating leases by the lessee as per AS-19?**
***(PYP 5 Marks May'22) ( SM)***

**Answer 1**

As per AS 19, lessees are required to make following disclosures for operating leases:

**(a)** the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:
  (i) not later than one year;
  (ii) later than one year and not later than five years;
  (iii) later than five years;

**(b)** the total of future minimum sublease payments expected to be received under non- cancelable subleases at the balance sheet date;

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

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

**(e)** a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;
(ii) the existence and terms of renewal or purchase options and escalation clauses; and
(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III non-corporate entities (and SMCs) need not make disclosures required by (a), (b) and (e) above.

**EXAM INSIGHTS:** Most of the examinees did not explain the disclosure requirements of Operating Leases by the Lessee as per AS 19 "Leases" in the required manner.

## Question 2

**Sun Limited wishes to obtain a machine costing Rs. 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Star Ltd., for a lease rental for Rs. 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Sun Limited is not sure about the treatment of these lease rentals and seeks your advise. You are required to explain the necessary accounting treatment in line with AS 19. (use annuity factor at @ 15% for 3 years as 3.36) *(MTP 5 Marks, Aug'18, RTP Nov '19, RTP May 21)***

**Answer 2**

As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment amounts to at least substantially all of the fair value of leased asset. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as:

Annuity Factor (Year 1 to Year 5) 3.36 (approx.)

Present Value of minimum lease payments (Rs. 3 lakhs each year) Rs. 10.08 lakhs (approx.)

Thus present value of minimum lease payments is Rs. 10.08 lakhs and the fair value of the machine is Rs. 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore, lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

## Question 3

**Sooraj Limited wishes to obtain a machine costing ₹ 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 3 years. It enters into an agreement with Star Ltd., for a lease rental for ₹ 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Sooraj Limited is not sure about the treatment of these lease rentals and seeks your advice. (use annuity factor at @ 15% for 3 years as 2.28) *(RTP May'24) (Same Concept Different figure MTP 5 Marks, Aug'18, RTP Nov '19, RTP May 21)***

**Answer 3**

As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment amounts to at least substantially all of the fair value of leased asset. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as:

| | |
|---|---|
| Annuity Factor (Year 1 to Year 3) | 2.28 |
| Present Value of minimum lease payments (₹ 3 lakhs each year) | ₹ 6.84 lakhs |

Thus present value of minimum lease payments is ₹ 6.84 lakhs and the fair value of the machine is ₹ 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for three years. Therefore, lease agreement is an operating lease. Lease payments under an operating lease should be recognized as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

## Question 4

**Wivitsu Ltd. sold machinery having WDV of Rs. 40 lakhs to B Ltd. for Rs. 50 lakhs and the same machinery was leased back by B Ltd. to Wivitsu Ltd. The lease back is operating lease. Explain the accounting treatment as per AS 19 in the following cases:**

**(i) Sale price of Rs. 50 lakhs is equal to fair value.**

**(ii) Fair value is Rs. 45 lakhs and sale price is Rs. 38 lakhs.**

**(iii) Fair value is Rs. 40 lakhs and sale price is Rs. 50 lakhs.**

**(iv) Fair value is Rs. 46 lakhs and sale price is Rs. 50 lakhs**

**(v) Fair value is Rs. 35 lakhs and sale price is Rs. 39 lakhs. *(MTP 5 Marks Mar'18, Oct'18, PYP 5 Marks, May '18) (Same concept different figures PYP 5 Marks Jan 21, MTP 5 Marks Oct'20, MTP 5 Marks Oct'21, SM, MTP 4 Marks Nov'24)***

**Answer 4**

**The following will be the treatment in the given cases:**

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

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

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

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

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

## Question 5

**(a) Classify the following into either operating or finance lease:**

**(i) If Present value (PV) of Minimum lease payment (MLP) = "X"; Fair value of the asset is "Y" and X=Y.**

**(ii) The economic life of the asset is 7 years, lease term is 6.5 years, but asset is not acquired at the end of the lease term;**

**(iii) The economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee . *(RTP Nov 20)***

**(b) Viral Ltd. sold machinery having WDV of Rs. 40 lakhs to Saral Ltd. for Rs. 50 lakhs and the same machinery was leased back by Saral Ltd. to Viral Ltd. The lease back is in nature of operating lease. You are required to explain the treatment in the given cases –**

**(i) The fair value is Rs. 45 lakhs and sale price is Rs. 38 lakhs.**

**(ii) The fair value is Rs. 40 lakhs and sale price is Rs. 50 lakhs.**

**(iii) The fair value is Rs. 46 lakhs and sale price is Rs. 50 lakhs *(RTP Nov 20, May 22)***

**Answer 5**

**(i)** The lease is a finance lease if X = Y, or if X substantially equals Y.

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

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

As per AS 19, where sale and leaseback results in operating lease, then the accounting treatment in different situations is as follows:

**Situation 1:** Sale price = Fair Value

Profit or loss should be recognized immediately.

**Situation 2:** Sale Price < Fair Value

Profit should be recognized immediately. The loss should also be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

**Situation 3**: Sale Price > Fair Value

The excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

**The following will be the treatment in the situations given in the question:**

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

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

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

## Question 6

**Aksat International Limited has given a machinery on lease for 36 months, and its useful life is 60 months. Cost & fair market value of the machinery is Rs. 5,00,000. The amount will be paid in 3 equal annual installments and the lessee will return the machinery to lessor at termination of lease. The unguaranteed residual value at the end of 3 years is Rs. 50,000. IRR of investment is 10% and present value of annuity factor of Rs. 1 due at the end of 3 years at 10% IRR is 2.4868 and present value of Rs. 1 due at the end of 3rd year at 10% IRR is 0.7513.**

**You are required to comment with reason whether the lease constitute finance lease or operating lease. If it is finance lease, calculate unearned finance income. *(RTP May 19) (MTP 5 Marks Sep '23)***

**Answer 6**

**Determination of Nature of Lease**

Present value of unguaranteed residual value at the end of 3rd year = Rs. 50,000 x 0.7513= Rs. 37,565

Present value of lease payments = Rs. 5,00,000 – Rs. 37,565= Rs. 4,62,435

The percentage of present value of lease payments to fair value of the equipment is

(Rs. 4,62,435/ Rs. 5,00,000) x 100 = 92.487%.

Since lease payments substantially covers the major portion of the fair value; the lease constitutes finance lease.

Calculation of Unearned Finance Income

Annual lease payment = Rs. 4,62,435/ 2.4868 = Rs. 1,85,956 (approx.)

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

= (Rs. 1,85,956 × 3) + Rs. 50,000

= Rs. 5,57,868 + Rs. 50,000 = Rs. 6,07,868

Unearned finance income

= Gross investment - Present value of minimum lease payments and unguaranteed residual value

= Rs. 6,07,868 – Rs. 5,00,000 = Rs. 1,07,868

## Question 7

**WIN Ltd. has entered into a three year lease arrangement with Tanya sports club in respect of Fitness Equipments costing ₹ 16,99,999.50. The annual lease payments to be made at the end of each year are structured in such a way that the sum of the Present Values of the lease payments and that of the residual value together equal the cost of the equipments leased out. The unguaranteed residual value of the equipment at the expiry of the lease is estimated to be ₹ 1,33,500. The assets would revert to the lessor at the end of the lease. Given that the implicit rate of interest is 10%. You are required to calculate the amount of the annual lease payment and the unearned finance income. Discounting Factor at 10% for years 1, 2 and 3 are 0.909, 0.826 and 0.751 respectively. *(RTP May'18, May '23)***

**Answer 7**

**I. Computation of annual lease payment to the lessor**

| | ₹ |
|---|---|
| Cost of equipment | 16,99,999.50 |
| Unguaranteed residual value | 1,33,500.00 |
| Present value of residual value after third year @ 10% (₹ 1,33,500 × 0.751) | 1,00,258.50 |
| Fair value to be recovered from lease payments (₹ 16,99,999.5– ₹ 1,00,258.5) | 15,99,741.00 |
| Present value of annuity for three years is 2.486 | |
| Annual lease payment = ₹ 15,99,741/ 2.486 | 6,43,500.00 |

**II. Computation of Unearned Finance Income**

| | ₹ |
|---|---|
| Total lease payments (₹ 6,43,500 x 3) | 19,30,500 |
| Add: Unguaranteed residual value | 1,33,500 |
| Gross investment in the lease | 20,64,000.00 |
| Less: Present value of investment (lease payments and residual value) (₹ 1,00,258.5+ ₹ 15,99,741) | (16,99,999.50) |
| Unearned finance income | 3,64,000.50 |

## Question 8

**Color Limited leased a Machine to Red Limited on 1 April, 2021 on the following:**

| | |
|---|---|
| **Cost of the machine** | **₹ 18,00,000** |
| **Lease term** | **3 Years** |
| **Fair market value of the machine** | **₹ 18,00,000** |
| **Unguaranteed residual value as on 31.3.2024** | **₹ 2,00,000** |
| **Internal rate of return** | **12%** |

**Other information:**

**The expected useful life of the machine is 5 years. The machine will revert to Colour Limited on termination of the lease. The lease payment is to be made at the end of each year in 3 equal parts.**

**The present value of ₹ 1 due at the end of 3rd year at 12% rate of interest is ₹ 0.7118. The present value of annuity of at ₹ 1 due at the end of 3rd year at 12% IRR is ₹ 2.4018.**

**You are required to analyze whether lease constitutes finance lease. Also calculate unearned finance income, if any. *(PYP 4 Marks May'24) (Same concept different figures SM)***

**Answer 8**

**Computation of Annual Lease Payment**

| **Particulars** | **Amount** |
|---|---|
| Cost of Equipment | 18,00,000 |
| Unguaranteed Residual Value | 2,00,000 |
| Present Value of unguaranteed residual value(₹200,000 x 0.7118) | 1,42,360 |
| Present Value of Lease Payments(₹18,00,000 – ₹1,42,360) | 16,57,640 |
| Present Value of Annuity for three years is 2.4018<br>Annual Lease Payment (16,57,640 / 2.4018) | 6,90,165.71 |

**Classification of Lease:**

**Parameter 1:**

The present value of lease payment i.e. ₹16,57,649 which equals 92.09% ofthe fair market value i.e., ₹ 18,00,000.

The present value of minimum lease payments is substantially covers thefair value of the leased asset

**Parameter 2:**

The lease term (i.e. 3 years) covers the major part of the life of the asset (i.e.5 years).

Therefore, it constitutes a finance lease.

**Computation of unearned Finance Income:**

| Particulars | Amount |
|---|---|
| Total Lease Payments (₹6,90,165 x 3) | ₹20,70,495 |
| Add: Unguaranteed residual value | ₹2,00,000 |
| | ₹22,70,495 |
| Less: Present value of lease payments and residual value i.e. Net investment (1,42,360+16,57,640) | ₹ 18,00,000 |
| Unearned Finance Income | ₹ 4,70,495 |

## Question 9

**Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being ₹ 7,00,000.**
**The economic life of machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays ₹ 3,00,000. The Lessee has guaranteed a residual value of ₹ 22,000 on expiry of the lease to the Lessor. However, Lessor Ltd., estimates that the residual value of the machinery will be only ₹ 15,000. The implicit rate of return is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively. Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year.** ***(MTP 5 Marks Mar'24)(Same Concept Different Figure MTP 5 Marks Apr'19, Oct'19, Mar'19, RTP May 20,Nov 18 & Nov'23, SM)***

**Answer 9**

As per AS 19 "Leases", the lessee should recognize the lease as an asset and a liability at the inception of a finance lease. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount
recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Computation of Value of machinery:
Present value of minimum lease payment = ₹ 6,99,054 (See working note below)
Fair value of leased asset = ₹ 7,00,000
Therefore, the recognition will be at the lower of the two i.e. 6,99,054
Working Note - Present value of minimum lease payments:
Annual lease rental × PVIF+ Present value of guaranteed residual value
= ₹ 3,00,000 × (0.869 + 0.756 + 0.657) + ₹ 22,000 × 0.657
= ₹ 6,84,600 + ₹ 14,454 = 6,99,054

**Computation of finance charges:**

| Year | Finance charge | Payment | Reduction in outstanding liability | Outstanding liability |
|---|---|---|---|---|
| 1st Year beginning | – | – | – | 6,99,054 |
| End of 1st year | 1,04,858 | 3,00,000 | 1,95,142 | 5,03,912 |
| End of 2nd year | 75,587 | 3,00,000 | 2,24,413 | 2,79,499 |
| End of 3rd year | 41,925 | 3,00,000 | 2,58,075 | 21,424 |

## Question 10

**S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:**
**Lease term = 4 years**
**Fair value at inception of lease = ₹ 20,00,000 Lease rent = ₹ 6,25,000 p.a. at the end of year Guaranteed residual value = ₹ 1,25,000 Expected residual value = ₹ 3,75,000 Implicit interest rate = 15% Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.**
**You are required to calculate the value of the lease liability as per AS-19 and also disclose impact of this on Balance sheet and Profit & loss account at the end of year 1.** ***(MTP 5 Marks Nov '21 & April '23, SM)(Same concept different figures MTP 5 Marks Oct'22, PYP 5 Marks May '19)***

**Answer 10**

According to AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the lower of the fair value of the leased asset at the inception of the finance lease and the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

| Year | Minimum Lease Payment ₹ | Implicit interest rate (Discount rate @15%) | Present value ₹ |
|---|---|---|---|
| 1 | 6,25,000 | 0.8696 | 5,43,500 |
| 2 | 6,25,000 | 0.7561 | 4,72,563 |
| 3 | 6,25,000 | 0.6575 | 4,10,937 |
| 4 | 7,50,000 | 0.5718 | 4,28,850 |
| Total | 26,25,000 | | 18,55,850 |

Present value of minimum lease payments ₹ 18,55,850 is less than fair value at the inception of lease i.e. ₹ 20,00,000, therefore, the asset and corresponding lease liability should be recognized at ₹ 18,55,850 as per AS 19.Minimum Lease Payment of 4thyear includes guaranteed residual value amounting ₹ 1,25,000

## Question 11

**Money Limited leased a machine to Vivtsu Limited on the following terms:**

| | | (₹ in lakh) |
|---|---|---|
| (i) | Fair value of the machine | 24.00 |
| (ii) | Lease term | 5 years |
| (iii) | Lease rental per annum | 4.00 |
| (iv) | Guaranteed residual value | 0.8 |
| (v) | Expected residual value | 1.5 |
| (vi) | Internal rate of return | 15% |

**Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively. Ascertain Unearned Finance Income.** ***(RTP Jan'25)***

**Answer 11**

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

Where:

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

**Gross investment** = Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value (GRV)] + Unguaranteed residual value (URV)

= [(₹ 4,00,000 × 5 years) + ₹ 80,000] + ₹ 70,000

= ₹ 21,50,000 (a)

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

| Year | MLP inclusive of URV ₹ | Internal rate of return (Discount factor @ 15%) | Present Value ₹ |
|---|---|---|---|
| 1 | 4,00,000 | 0.8696 | 3,47,840 |
| 2 | 4,00,000 | 0.7561 | 3,02,440 |
| 3 | 4,00,000 | 0.6575 | 2,63,000 |
| 4 | 4,00,000 | 0.5718 | 2,28,720 |
| 5 | 4,00,000 | 0.4972 | 1,98,880 |
| | 80,000 (GRV) | 0.4972 | 39,776 |
| | 20,80,000 | | 13,80,656 (i) |
| | 70,000 (URV) | 0.4972 | 34,804 (ii) |
| | 21,50,000 | (i)+ (ii) | 13,45,852(b) |

**Unearned Finance Income** (a) - (b) = ₹ 21,50,000 – ₹ 13,45,852 = ₹ 8,04,148.

## Question 12

LDR

**A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost of ₹ 2,25,000. Economic life of the machine is 5 years and output from the machine is estimated as 60,000 units, 75,000 units, 90,000 units, 1,20,000 units and 1,05,000 units**

consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate. You are required to compute the following as per AS-19.

(i) Annual Lease Rent

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

(iii) Depreciation for 3 years *lease (PYP 5 Marks Dec'21, MTP 4 Marks March 21 , MTP 4 Marks May 20, SM)*

**Answer 12**

**i. Annual lease rent**

Total lease rent

= 130% of ₹ 2,25,000 X Output during lease period/ Total output

= 130% of ₹ 2,25,000 x (60,000 +75,000+ 90,000)/(60,000 + 75,000 + 90,000 + 1,20,000 + 1,05,000)

= 2,92,500 x 2,25,000 units/4,50,000 units = ₹ 1,46,250

Annual lease rent = ₹ 1,46,250 / 3 = ₹ 48,750

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

Total lease rent should be recognized as income in proportion of output during lease period, i.e. in the proportion of 60,000 : 75,000 : 90,000 or 4:5:6

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

Year 1 ₹ 39,000,

Year 2 ₹ 48,750 and

Year 3 ₹ 58,500.

**iii. Depreciation for three years of lease**

Since depreciation in proportion of output is considered appropriate, the depreciable amount ₹ 2,25,000 should be allocated over useful life 5 years in proportion of output,

i.e. in proportion of 60 :75: 90: 120 : 105 .

Depreciation for year 1 is ₹ 30,000, year 2 = 37,500 and year 3 = 45,000.

**EXAM INSIGHTS:** Few examinees made mistakes in computation of Annual Lease Rent, Lease Rent income to be recognized in each operating year and depreciation for three years of lease.

## Question 13

You are required to give the necessary journal entry at the inception of lease to record the asset taken on finance lease in books of lessee from the following information:

| | | |
|---|---|---|
| Lease period | = | 5 years; |
| Annual lease rents | = | ₹ 50,000 |
| | | at the end of each year. |
| Guaranteed residual value | = | ₹ 25,000 |
| Fair Value at the inception (beginning) of lease | = | ₹ 2,00,000 |

Interest rate implicit on lease is = 12.6% (Discounted rates for year 1 to 5 are .890, .790, .700, .622 and .552 respectively). *(MTP 7 Marks Aug'24) ). (MTP 5 Marks April 21, April 22)*

**Answer 13**

**Present value of minimum lease payment is computed below:**

| Year | MLP | DF (12.6%) | PV |
|---|---|---|---|
| | ₹ | | ₹ |
| 1 | 50,000 | 0.890 | 44,500 |
| 2 | 50,000 | 0.790 | 39,500 |
| 3 | 50,000 | 0.700 | 35,000 |
| 4 | 50,000 | 0.622 | 31,100 |
| 5 | 50,000 | 0.552 | 27,600 |
| 5 | 25,000 | 0.552 | 13,800 |
| | | | 1,91,500 |

Present value of minimum lease payment = ₹ 1,91,500

Fair value of leased asset = ₹ 2,00,000

As per AS 19, on the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of Fair value of leased asset at the inception of the lease and present value of minimum lease payments from the standpoint of the lessee. The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

| | | ₹ | ₹ |
|---|---|---|---|
| Asset A/c | Dr. | 1,91,500 | |
| To Lessor (Lease Liability) A/c | | | 1,91,500 |
| (Being recognition of finance lease as asset andliability) | | | |

## Question 14

LDR

**Sun Limited leased a machine to Moon Limited on the following terms:**

| | (Amount in ₹) |
|---|---|
| Fair value at inception of lease | 50,00,000 |
| Lease Term | 4 Years |
| Lease Rental per annum | 16,00,000 |
| Guaranteed residual value | 3,00,000 |
| Expected residual value | 4,50,000 |
| Implicit Interest rate | 15% |

**Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively. Calculate the value of Lease Liability and ascertain Unearned Finance Income as per AS-19.** ***(MTP 5 Marks Sep'22) (Same concept different figures SM)***

**Answer 14**

According to AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

| Year | Minimum Lease Payment ₹ | Internal rate of return (Discount rate @15%) | Present value ₹ |
|---|---|---|---|
| 1 | 16,00,000 | 0.8696 | 13,91,360 |
| 2 | 16,00,000 | 0.7561 | 12,09,760 |
| 3 | 16,00,000 | 0.6575 | 10,52,000 |
| 4 | 19,00,000 | 0.5718 | **10,86,420** |
| Total | 67,00,000 | | **47,39,540** |

Present value of minimum lease payments i.e. ₹ 47,39,540 is less than fair value at the inception of lease i.e. ₹ 50,00,000, therefore, the value of lease is ₹ 47,39,540 and lease liability should be recognized in the books at ₹ 47,39,540 as per AS 19.

**Calculation of Unearned Finance Income**

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

**Where:**

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

**Gross investment** = Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value(GRV)] + Unguaranteed residual value (URV)

= [(₹ 16,00,000 ×4 years) + ₹ 3,00,000] + ₹ 1,50,000 = ₹ 68,50,000

II. **Present value of minimum lease payment from Lessor's view point**

Lease liability ₹ 47,39,540 + present value of (URV) unguaranteed residual value

(₹ 1,50,000 x 0.5718) = ₹ 48,25,310

Unearned Finance Income = (a) – (b) = ₹ 68,50,000 – ₹ 48,25,310= ₹ 20,24,690

*Minimum Lease Payment of 4th year includes guaranteed residual value amounting i.e 16,00,000 + 3,00,000 =19,00,000.

## Multiple Choice Questions (MCQs)

1. **Wivitsu Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs (Fair value ₹ 50 lakhs) and same machinery was leased back by B Ltd. to Wivitsu Ltd. The lease back is in nature of operating lease. The treatment will be *(SM)***
   (a) Wivitsu Ltd. should amortise the profit of ₹ 10 lakhs over lease term.
   (b) Wivitsu Ltd. should recognise the profit of ₹ 10 lakhs immediately.
   (c) Wivitsu Ltd. should defer the profit of ₹ 10 lakhs.
   (d) B Ltd. should recognise the profit of ₹ 10 lakhs immediately.

**Ans: (b)**

2. **In case of an operating lease – identify which statement is correct: *(SM)***
   (a) The lessor continues to show the leased asset in its books of accounts.
   (b) The lessor de-recognises the asset from its Balance Sheet.
   (c) The lessor discontinues to claim depreciation in its books.
   (d) The lessee recognises the asset in its Balance Sheet.

**Ans: (a)**

3. **In case of finance lease, if the asset is returned back to the lessor at the end of the lease term - the lessee always claims depreciation based on which of the following: *(SM)***
   (a) Useful life.
   (b) Lease term.
   (c) Useful life or lease term whichever is less.
   (d) Useful life or lease term whichever is higher.

**Ans: (c)**

4. **AS 19 lays down 5 deterministic conditions to classify the lease as a finance lease. To classify the lease as an operating lease – which statement is correct? *(SM)***
   (a) Any 1 condition fails.
   (b) Majority of the 5 conditions fail.
   (c) All 5 conditions fail.
   (d) Any 2 conditions fails.

**Ans: (c)**

5. **The basis of classification of a lease is: *(SM)***
   (a) Control Test.
   (b) Risk and reward Test.
   (c) Both control test and risk and reward test.
   (d) Only reward Test

**Ans: (b)**

6. **As per Accounting Standards, difference between the Gross Investment and the present value of Minimum Lease Payments under finance lease (from the standpoint of the lessor) and Unguaranteed Residual Value accruing to the lessor is recorded as *(MTP 2 Marks Apr'24)***
   (a) Unearned finance income
   (b) Guaranteed Residual Value
   (c) Profit on lease
   (d) Loss on lease

**Ans: (a)**

7. **Accounting Standard 19, Lease is applicable on following Leases: *(MTP 2 Marks Dec'24)***
   (a) Lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights.
   (b) Legal owner of an asset conveys to another party in return for a payment or series of periodic payments, the right to use an asset for an agreed period of time.
   (c) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.
   (d) lease agreements to use lands

**Ans: (b)**

B

# CHAPTER 5.6: AS 26 INTANGIBLE ASSETS

| CONCEPTS OF THIS CHAPTER | | LDR Questions |
|---|---|---|
| • Intangible Assets | • Amortization Principles | Q 13 |
| • Separate Acquisition | • Amortization Period | |
| • Amalgamation | • Exchanges of Assets | |
| • Government Grant | • Amortization Method | |
| • Retirements and Disposals | • Residual Value | |
| • Internally Generated Goodwill | • Review | |
| • Subsequent Measurement | • Disclosures | |
| • Recognition and Initial Measurement | | |

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Impairment Loss-** Amount by which Carrying amount of an asset exceeds its recoverable amount

**Carrying Amount-** Amount at which an asset is recognised in the balance sheet. Net of any accumulated amortisation and accumulated impairment losses thereon.

**Intangible Assets:**Is identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes

**Internally Generated Goodwill**

- Internally generated goodwill
- is not recognised as an asset
- because it is not an identifiable resource
- controlled by the enterprise
- that can be measured reliably at cost.

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into

| Research Phase | Development Phase |
|---|---|
| Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. | Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use. |

**Recognition of an Expense**

**Expenditure on an intangible item should be recognized as an expense when it is incurred unless:**

| | |
|---|---|
| It forms part of the cost of an intangible asset that meets the recognition criteria | The item is acquired in an amalgamation in the nature of purchase and cannot be recognized as an intangible asset. |

**Subsequent Expenditure**

**Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless**

| | |
|---|---|
| It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standardof performance | Expenditure can be measured and attributed to the asset reliably. |

**Measurement Subsequent to Initial Recognition**

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

**Amortisation Method**

- A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method.
- The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period.

**Residual Value** -Residual value is the amount, which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

**The residual value of an intangible asset should be assumed to be zero unless**

- There is a commitment by a third party to purchase the asset at the end of its useful life
- There is an active market for the asset and:
  - i. Residual value can be determined by reference to that market and
  - ii. It is probable that such a market will exist at the end of the asset's useful life.

**Retirements and Disposals**

**An intangible asset should be derecognised (eliminated from the balance sheet) if**

- Disposed
- When no future economic benefits are expected from its use and subsequent disposal.

**Disclosure**

**The financial statements should disclose for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets**

- Useful lives or the amortisation rates used.
- Amortisation methods used
- Gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
- A reconciliation of the carrying amount at the beginning and end of the period showing:
  - Additions, indicating separately those from internal development and through amalgamation
  - Retirements and disposals.
  - Impairment losses recognised in the statement of profit and loss.
  - Impairment losses reversed in the statement of profit and loss.
  - Amortisation recognised during the period and
  - Other changes in the carrying amount during the period.



## Question & Answers

### Question 1

**PQR Ltd. has acquired a Brand from another company for Rs. 100 lakhs. PQR Ltd. contends that since the said brand is a very popular and famous brand, no amortization needs to be provided. Comment on this in line with the Accounting Standards. *(RTP, May 22)***

**Answer 1**

AS 26 'Intangible Assets" provides that an intangible asset should be measured initially at cost. After initial recognition, an intangible asset should be carried at cost less any accumulated amortization and any accumulated impairment losses. The amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life for computing amortization. There is a rebuttable presumption that the useful life of an intangible asset will not exceed 10 years from the date when the asset is available for use. It must be ensured that the value of brand is amortized in accordance with AS 26, as brand is considered to be intangible asset. The contention of PQR Ltd. that Brand is very popular and famous, hence no amortization needs to be provided is not correct as there is no persuasive evidence that the useful life of the intangible asset will exceed 10 years.

### Question 2

**X Ltd. is engaged in the business of newspaper and radio broadcasting. It operates through different brand names. During the year ended 31st March 2021, it incurred substantial amount on business communication and branding expenses by participation in various corporate social responsibility initiatives. The company expects to benefit by this expenditure by attracting new customers over a period of time and accordingly it has capitalized the same under brand development expenses and intends to amortize the same over the period in which it expects the benefits to flow. As the accountant of the company do you concur with these**

**views? You are required to explain in line with provisions of Accounting Standards.** ***(RTP May 22)***

**Answer 2**

As per AS 26 on Intangible Assets, expenditure on an intangible item should be recognized as on expense when it is incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria. An intangible asset should be recognized if, and only if: (i) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and (ii) the cost of the asset can be measured reliably. In the given case, no intangible assets or other asset is acquired or created that can be recognized, the accounting treatment by the company to amortize the entire expenditure over the period in which it expects the benefits to flow is not correct and the same should be debited to the profit and loss statement during the year ended 31st March, 2021.

## Question 3

**X Ltd. carried on business of manufacturing of Bakery products. The company has two trademarks "Sun" and "Surya". One month before the company knows through one of the marketing managers that both trademarks have allegedly been infringed by other competitors engaged in the same field. After investigation, legal department of the company informed that it had weak case on trademark "Sun" and strong case in regard to trademark "Surya". X Ltd. incurred additional legal fees to stop infringement on both trademarks. Both trademarks have a remaining legal life of 10 years. How should X Ltd. account for these legal costs incurred relating to the two trademarks? .*(MTP 5 Marks March '23, RTP Nov'20)***

**Answer 3**

As per para 59 of AS 26, subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense. However, if the subsequent expenditure enables the asset to generate future economic benefits in excess of its originally assessed standard of performance or can be measured and attributed to the asset reliably, then such subsequent expenditure should be added to the cost of the intangible asset. The legal costs incurred for both the trademarks do not enable them to generate future economic benefits in excess of its originally assessed standard of performance. They only ensure to maintain them if the case is decided in favour of the company. Therefore, such legal costs must be recognised as an expense.

## Question 4

**K Ltd. launched a project for producing product X in October, 2023. The Company incurred ₹ 40 lakhs towards Research and Development expenses upto 31st March, 2024. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years. Advise the Company as per the applicable Accounting Standard. (*MTP 5 Marks Apr'24) MTP-Mar'19 5 Marks, RTP Nov 19, May 18, RTP Nov'22, Old & New SM)***

**Answer 4**

As per AS 26 "Intangible Assets", expenditure on research should be recognized as an expense when it is incurred. An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the conditions specified in para 44 of the standard. An intangible asset (arising from development) should be derecognised when no future economic benefits are expected from its use according to para 87 of the standard. Thus, the manager cannot defer the expenditure write off to future years in the given case.

Hence, the expenses amounting ₹ 40 lakhs incurred on the research and development project has to be written off in the current year ending 31st March 2024.

## Question 5

**As per provisions of AS-26, how would you deal to the following situations:**

(1) **₹ 23,00,000 paid by a manufacturing company to the legal advisor for defending the patent of a product is treated as a capital expenditure.**

(2) **During the year 2021-22, a company spent ₹ 7,00,000 for publicity and research expenses on one of its new consumer product which was marketed in the same accounting year but proved to be a failure.**

(3) **A company spent ₹ 25,00,000 in the past three years to develop a product, these expenses were charged to profit and loss account since they did not meet AS-26 criteria for capitalization. In the current year approval of the concerned authority has been received. The company wishes to capitalize ₹ 25,00,000 by disclosing it as a prior period item.**

(4) **A company with a turnover of ₹ 200 crores and an annual advertising budget of ₹ 50,00,000 had taken up for the marketing of a new product by a company. It was estimated that the company would have a turnover of ₹ 20 crore from the new product. The company had debited to its Profit & Loss Account the total expenditure of ₹ 50,00,000 incurred on extensive special initial advertisement campaign for the new product.** ***(RTP May '23, PYP Nov '19 5 Marks, MTP 5 Marks Nov'24) (Same concept different figures RTP May'19,SM)***

**Answer 5**

As per AS 26 "Intangible Assets", subsequent expenditure on an intangible asset after its purchase or its completion should be recognized as an expense when it is incurred unless (a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and (b) expenditure can be measured and attributed to the asset reliably. If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

(i) In the given case, the legal expenses to defend the patent of a product amounting ₹ 23,00,000 should not be capitalized and be charged to Profit and Loss Statement.

(ii) The company is required to expense the entire amount of ₹ 7,00,000 in the Profit and Loss account for the year ended 31st March, 2022 because no benefit will arise in the future.

(iii) As per AS 26, expenditure on an intangible item that was initially recognized as an expense by a reporting enterprise in previous annual financial statements should not be recognized as part of the cost of an intangible asset at a later date. Thus the company cannot capitalize the amount of ₹ 25,00,000 and it should be recognized as expense

(iv) Expenditure of ₹ 50,00,000 on advertising and promotional activities should always be charged to Profit and Loss Statement. Hence, the company has done the correct treatment by debiting the sum of 50 lakhs to Profit and Loss Account

## Question 6

**Vivitzu Ltd. is showing an intangible asset at Rs. 72 lakhs as on 31-3-2022. This asset was acquired for Rs. 120 lakhs as on 01-04-2016 and the same was used from that date. The company has been following the policy of amortization of the intangible assets over a period of 15 years, on straight line basis. You are required to comment on the accounting treatment of asset with reference to AS 26 "Intangible Assets" and also give the necessary rectification journal entry in the books.** ***(MTP 5 Marks April 22, MTP 4 Marks March'21, RTP Nov '21)***

**Answer 6**

As per AS 26 'Intangible Assets', the depreciable amount of an intangible asset should be allocated on systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. The Company has been following the policy of amortization of the intangible asset over a period of 15 years on straight line basis. The period of 15 years is more than the maximum period of 10 years specified as per AS 26. Accordingly, the company would be required to restate the carrying amount of intangible asset as on 31.3.2022 at Rs. 48 lakhs i.e. Rs. 120 lakhs less Rs. 72 lakhs (Rs. 120 Lakhs / 10 years x 6 years = 72 Lakhs). The difference of Rs. 24 Lakhs (Rs. 72 lakhs – Rs. 48 lakhs) will be adjusted against the opening balance of revenue reserve. The carrying amount of Rs. 48 lakhs will be amortized over remaining 4 years by amortizing Rs. 12 lakhs per year.

| | | |
|---|---|---|
| The necessary journal entry (for rectification) will be Revenue Reserves Dr. | Rs. 24 Lakhs | |
| To Intangible Assets | | Rs. 24 Lakhs |

(Adjustment to reserves due to restatement of the carrying amount of intangible asset)

## Question 7

**Plymouth Ltd. is engaged in research on a new process design for its product. It had incurred Rs. 10 lakh on research during first 5 months of the financial year 2020-21. The development of the process began on 1st September, 2020 and up to 31st March, 2021, a sum of Rs. 8 lakhs were incurred as Development Phase Expenditure, which meets assets recognition criteria. From 1st April, 2021, the Company has implemented the new process design and it is likely that this will result in after tax saving of Rs. 2 lakhs per annum for next five years. The cost of capital is 10%. The present value of annuity factor of Rs. 1 for 5 years @ 10% is 3.7908. Decide the treatment of Research and Development Cost of the project as per AS 26.** ***(MTP 5 Marks April 21)***

**Answer 7**

Research Expenditure – According to AS 26 'Intangible Assets', the expenditure on research of new process design for its product Rs. 10 lakhs should be charged to Profit and Loss Account in the year in which it is incurred. It is presumed that the entire expenditure is incurred in the financial year 2020-21. Hence, it should be written off as an expense in that year itself.

Cost of internally generated intangible asset – it is given that development phase expenditure amounting Rs. 8 lakhs incurred up to 31st March, 2021 meets asset recognition criteria. As per AS 26, for measurement of such internally generated intangible asset, fair value should be estimated by discounting estimated future net cash flows.

| | |
|---|---|
| Savings (after tax) from implementation of new design for next 5 years | Rs. 2 lakhs p.a. |
| Company's cost of capital | 10 % |
| Annuity factor @ 10% for 5 years | 3.7908 |
| Present value of net cash flows (Rs. 2 lakhs x 3.7908) | Rs. 7.582 lakhs |

The cost of an internally generated intangible asset would be lower of cost value Rs. 8 lakhs or present value of future net cash flows Rs. 7.582 lakhs.

Hence, cost of an internally generated intangible asset will be Rs. 7.582 lakhs.

The difference of Rs. 0.418 lakhs (i.e. Rs. 8 lakhs – Rs. 7.582 lakhs) will be amortized by Plymouth for the financial year 2020-21. Amortization - The company can amortise Rs. 7.582 lakhs over a period of five years by charging Rs. 1.516 lakhs per annum from the financial year 2021-2022 onwards.

## Question 8

**A Company acquired for its internal use a software on 01.03.2020 from U.K. for £ 1,50,000. The exchange rate on the date was as ₹ 100 per £. The seller allowed trade discount @ 2.5%. The other expenditures were:**

**(i) Import Duty 10%**

**(ii) Additional Import Duty 5%**

**(iii) Entry Tax 2% (Recoverable later from tax department).**

**(iv) Installation expenses ₹ 1,50,000.**

**(v) Professional fees for clearance from customs ₹ 50,000.**

**Compute the cost of software to be Capitalized as per relevant AS.** ***(PYP 5 Marks , Jan 21)***



**Answer 8**

**Calculation of cost of software (intangible asset) acquired for internal use**

| | |
|---|---|
| Purchase cost of the software | £ 1,50,000 |
| Less: Trade discount @ 2.5% | £ ( 3,750) |
| | £1,46,250 |
| Cost in ₹ (UK £1,46,250 x ₹ 100) | 146,25,000 |
| Add: Import duty on cost @ 10% (₹) | 14,62,500 |
| | 160,87,500 |
| Add: Additional import duty @ 5% (₹) | 8,04,375 |
| | 168,91,875 |
| Add: Installation expenses (₹) | 1,50,000 |
| Add: Professional fee for clearance from customs (₹) | 50,000 |
| Cost of the software to be capitalized (₹) | 170,91,875 |

Note: Since entry tax has been mentioned as a recoverable / refundable tax, it is not included as part of the cost of the asset.

## Question 9

**Panna Limited purchased software from Agate Limited for a period of 5 years and capitalized the cost. It provided you the following information:**

**Cost of software ₹57,60,000. Expected Life cycle of the software 5 years**

**The software was amortised at ₹ 6,40,000 per annum in first three years based on economic benefits derived from the software. After three years, it was found that the software may be used for another 5 years from then. So, Panna Limited got it renewed after expiry of five years for 3 more years.**

The net cash flows from the software during these 5 years were expected to be as follows:

| | |
|---|---|
| Year 1 | ₹ 23,04,000 |
| Year 2 | ₹ 29,44,000 |
| Year 3 | ₹ 28,16,000 |
| Year 4 | ₹ 25,60,000 |
| Year 5 | ₹ 21,76,000 |

You are required to calculate the amortization cost of the software for each of the years. *(PYP 5 Marks Nov'23) (MTP 5 Marks Oct '20, Mar'22 & Oct '23)(Same concept different figures RTP Nov'18, SM, PYP 5 Marks May'18, RTP Nov'23)*

**Answer 9**

Panna Limited amortised ₹ 6,40,000 per annum for the first three years i.e.
₹ 19,20,000. The remaining carrying cost can be amortised during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

| ear | Net cash flows ₹ | Amortisation Ratio | Amortisation Amount ₹ |
|---|---|---|---|
| I | - | 0.1111 | 6,40,000 |
| II | | 0.1111 | 6,40,000 |
| III | - | 0.1111 | 6,40,000 |
| IV | 23,04,000 | 0.180 | 691200 |
| V | 29,44,000 | 0.230 | 883200 |
| VI | 28,16,000 | 0.220 | 844800 |
| VII | 25,60,000 | 0.200 | 768000 |
| IX | 21,76,000 | 0.170 | 652800 |
| Total | 1,28,00,000 | 1.000 | 57,60,000 |

It may be seen from above that from fourth year onwards, the balance of carrying amount i.e., ₹ 38,40,000 has been amortised in the ratio of net cash flows arising from the product of Panna Ltd.

<u>**EXAM INSIGHTS:**</u> A few examinees made mistakes in calculating the amortization ratio from the fourth year onwards.

## Question 10

**M/s. Pasa Ltd. is developing a new production process. During the financial year ended 31st March, 2019, the total expenditure incurred on the process was ₹ 80 lakhs. The production process met the criteria for recognition as an intangible asset on 1st November, 2018. Expenditure incurred till this date was ₹ 42 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2020 was ₹ 90 lakhs. As on 31.03.2020, the recoverable amount of know how embodied in the process is estimated to be ₹ 82 lakhs. This includes estimates of future cash outflows and inflows.**

**You are required to work out :**

**(1) What is the expenditure to be charged to Profit and Loss Account for the year ended 31st March, 2019 ?**

**(2) What is the carrying amount of the intangible asset as on 31st March, 2019?**

**(3) What amount of expenditure to be charged to Profit and Loss Account for the year ended 31st March, 2020 ?**

**What is the carrying amount of the intangible asset as on 31st March, 2020?** *(PYP 5 Marks Nov 20 & Dec '21) (Same concept lesser adjustments MTP 5 Marks Sep'22 & Sep '23)*

**Answer 10**

**As per AS 26 'Intangible Assets'**

**(i) Expenditure to be charged to Profit and Loss account for the year ending 31.03.2019**

₹ 42 lakhs is recognized as an expense because the recognition criteria were not met until 1st November, 2018. This expenditure will not form part of the cost of the production process recognized as an intangible asset in the balance sheet.

**(ii) Carrying value of intangible asset as on 31.03.2019**

At the end of financial year, on 31st March 2019, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 38 (80-42) lakhs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st November 2018)

**(iii) Expenditure to be charged to Profit and Loss account for the year ended 31.03.2020**

| | (₹ in lacs) |
|---|---:|
| Carrying Amount as on 31.03.2019 | 38 |
| Expenditure during 2019 – 2020 | 90 |
| Book Value | 128 |
| Recoverable Amount | (82) |
| Impairment loss to be charged to Profit and loss account | 46 |

₹ 46 lakhs to be charged to Profit and loss account for the year ending 31.03.2020.

**(iv) Carrying value of intangible asset as on 31.03.2020**

| | (₹ in lacs) |
|---|---:|
| Book Value | 128 |
| Less: Impairment loss | (46) |
| Carrying amount as on 31.03.2020 | 82 |

## Question 11

**During 2023-2024, an enterprise incurred costs to develop and produce a routine, low risk computer software product, as follows:**

| | Amount (₹) |
|---|---:|
| **Completion of detailed programme and design (Phase 1)** | **25,000** |
| **Coding and Testing for establishing technical feasibility (Phase 2)** | **20,000** |
| **Other coding costs (Phase 3)** | **42,000** |
| **Testing costs (Phase 4)** | **12,000** |
| **Product masters for training materials (Phase 5)** | **13,000** |
| **Duplication of computer software and training materials, from product masters (2,000 units) (Phase 6)** | **40,000** |
| **Packing the product (1,000 units) (Phase 7)** | **11,000** |

**After completion of phase 2, it was established that the computer software is technically feasible for the market. What amount should be capitalized as software costs in the books of the company, on the Balance Sheet date?** ***(RTP Jan'25, MTP 5 Marks May '20, Oct'21 & April '23, Old & New SM)***

**Answer 11**

As per para 44 of AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed programme design or working model. In this case, ₹ 45,000 would be recorded as an expense (₹ 25,000 for completion of detailed program design and ₹ 20,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (₹ 42,000 + ₹ 12,000 + ₹ 13,000) ₹ 67,000. Duplication of computer software and training materials, from product masters and packing the products are the cost incurred after development phase. Hence, the same shall be expensed off during the year it is incurred.

## Question 12

**In the following cases, record Journal Entries for amortization in the books of Huge Ltd. for the year ended 31st March, 2024 with reference to AS-26:**

(i) **The company had acquired Patent Rights for ₹ 340 lakhs on 01.04.2022. The estimated product life is 4 years. Amortization was decided in the ratio of estimated future cash flows which are as under:**
**1st Year ₹ 140 Lakhs**
**2nd Year ₹ 350 Lakhs**
**3rd Year ₹ 280 Lakhs**
**4th Year ₹ 420 Lakhs** ***(PYP 4 Marks Sep'24)***

(ii) **The company had developed know-how by incurring expenditure of ₹ 80 lakhs. The know-how has been used by the company since 01.04.2018. Its useful life is 8 years from the year of commencement of its use. The company has not amortised the asset until 31.03.2024.** ***(PYP 2 Marks Sep'24)***

**Answer 12**

**(i) Journal Entry for the year ended on 31st March 2024**

| | | | ₹ in lakhs | ₹ in lakhs |
|---|---|---|---|---|
| 31.3.24 | Amortization A/c (340 × 350/ 1,190) | Dr. | 100 | |
| | To Patent Rights A/c | | | 100 |
| | P&L A/c | Dr. | 100 | |
| | To Amortization A/c | | | 100 |

**Working note**

Huge Limited amortised ₹ 340 lakhs during next 4 years on the basis of net cash flows arising of the product. The amortisation for second year will be worked out as under:

₹ 340 x 350 /1,190 (140+350+280+420) = ₹ 100 lakhs

**(ii)**

| **Particulars** | | **₹ in lakhs** | **₹ in lakhs** |
|---|---|---|---|
| Prior period item | Dr. | 50 | |
| Amortization A/c | Dr. | 10 | |
| To Know-how A/c | | | 60 |
| [Being amortization of 6 years (out of which amortization of 5 years charged as prior period item i.e. 80 x 6 /8 = 60 lakhs)] | | | |
| Profit and Loss A/c | Dr. | 60 | |
| To Amortization A/c | | | 10 |
| To Prior Period Item<br>(Being amount transferred to Profit and Loss account) | | | 50 |

## Question 13

LDR

**Honey Ltd. is in the process of developing a new production method. During the financial year ended 31st March, 2023, total expenditure incurred on development of this production method was ₹ 98,00,000. On 1st Jan, 2023, the production method met the criteria as an intangible asset and expenditure incurred till this date was ₹ 68,00,000. Further expenditure incurred on the new method was ₹ 72,00,000 for the year ended 31st March, 2024 and recoverable amount of the know how embodied in the new method for this financial year is ₹ 52,00,000.**

**You are required to calculate:**

**(1) The carrying amount of the Intangible asset on 31st March, 2023.**

**(2) The expenditure to be shown in Statement of Profit and Loss for the year ended 31st March, 2024.**

**(3) The carrying amount of the Intangible asset on 31st March, 2024.** ***(MTP 7 Marks Dec'24)***

**Answer 13**

**As per AS 26 'Intangible Assets'**

**(i) Carrying value of intangible asset as on 31.03.2023**

At the end of financial year, on 31st March 2023, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 30 (98-68) lacs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st January, 2023).

**(ii) Expenditure to be charged to Profit and Loss account for the year ended 31.03.2024**

| | (₹ in lacs) |
|---|---|
| Carrying Amount as on 31.03.2023 | 30 |
| Expenditure during 2023–2024 | 72 |
| Book Value | 102 |
| Recoverable Amount | (52) |
| Impairment loss | 50 |

₹ 50 lakhs to be charged to Profit and loss account for the year ending 31.03.2024.

**(iii) Carrying value of intangible asset as on 31.03.2024**

| | (₹ in lacs) |
|---|---|
| Book Value | 102 |
| Less: Impairment loss | (50) |
| Carrying amount as on 31.03.2024 | 52 |

**Multiple Choice Questions (MCQs)**

1. **Which of the following is not covered within the scope of AS 26? *(SM)***
   (a) Intangible assets held-for-sale in the ordinary course of business
   (b) Assets arising from employee benefits
   (c) (a) & (b) both
   (d) Research and development activities

**Ans: (c)**

2. **Intangible asset is recognised if it: *(SM)***
   (a) meets the definition of an intangible asset
   (b) is probable that future economic benefits will flow
   (c) the cost can be measured reliably
   (d) meets all of the above parameters

**Ans: (d)**

3. **Sun Limited has purchased a computer with various additional software. These are integral part of the computer. Which of the following are true in the context of AS 26: *(SM)***
   (a) Recognise Computer and software as tangible asset
   (b) Recognise tangible and intangible separately
   (c) Recognise computer and software as intangible asset
   (d) Does not recognize the software as an asset.

**Ans: (a)**

4. **Wiwitsu Ltd developed a technology to enhance the battery life of mobile devices. Wiwitsu has capitalised development expenditure of ₹ 5,00,000. Wiwitsu estimates the life of the technology developed to be 3 years but the company has forecasted that 50% of sales will be in year 1, 35% in year 2 and 15% in year 3. What should be the amortisation charge in the second year of the product's life? *(SM)***
   (a) ₹ 2,50,000
   (b) ₹ 1,75,000
   (c) ₹ 1,66,667
   (d) ₹ 1,85,000

**Ans: (b)**

C

# CHAPTER 5.7: AS 28 IMPAIRMENT OF ASSETS

**CONCEPTS OF THIS CHAPTER**

- Recoverable Amount
- Value in Use
- Net Selling Price
- Cost of Disposal
- Impairment Loss
- Identify Impaired Asset
- Measure Recoverable Amount
- Recognize Impairment Loss
- Identify Cash-Generating Units
- Goodwill and CGU
- Impair Cash-Generating Unit
- Reversing Impairment Loss
- Impairment in Discontinued Operations
- Compute Cash-Generating Unit's Recoverable & Carrying Amount

LDR

**LDR Questions**
**Q 6**

## QUICK REVIEW OF IMPORTANT CONCEPTS



### Indicators of Impairment

**External sources of information**

- The asset's market value has declined significantly beyond normal depreciation.
- Adverse technological, market, economic, or legal changes have occurred or are imminent.
- Increased market interest rates may lower the asset's recoverable amount.
- The enterprise's net assets exceed its market capitalization.

**Internal sources of information**

- Evidence of obsolescence or physical damage exists.
- Adverse changes in asset use, including plans for discontinuation, restructuring, or early disposal.
- Internal reports indicate worse-than-expected economic performance.

### Recognition and Measurement of an Impairment Loss

**Case I:** If recoverable amount of assets > carrying amount, we ignore the difference and asset is carried on at the same book value. **Note:** As mentioned above, if there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard 10, even if no impairment loss is recognised for the asset.

**Case II:** When this recoverable amount < carrying amount, this difference termed as Impairment Loss.

**Accounting implications:**

| | |
|---|---|
| **Treatment of Impairment loss** | It should be written off immediately as expenses to Profit & Loss Account.<br>If assets are carried out at revalued figures then the impairment loss equivalent to revalued surplus is adjusted with it and the balance (if any) is charged to Profit & Loss Account. |
| **Depreciation** | Depreciation for the coming years on the assets are recalculated on the basis of the new carrying amount, residual value and remaining useful life of the asset, according to AS 10. |

**Case III:** When the amount estimated for an impairment loss is > carrying amount of the asset to which it relates, an enterprise should recognise a liability if, and only if, that is required by another Accounting Standard.

### Reversal of an Impairment Loss for an Individual Asset

| | |
|---|---|
| **Case I:** | If impairment loss was written off to profit and loss account, then the reversal of impairment loss should be recognized as income in the financial statement immediately. |
| **Case II:** | If impairment loss was adjusted with the Revaluation Reserve; then reversal of impairment loss will be written back to the reserve account to the extent it was adjusted, any surplus will be recognised as |

revenue. But in any case the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

**Depreciation impact post reversal of impairment loss:** After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

### Goodwill Corporate Assets

- Can be allocated on a reasonable and consistent basis
  – Perform Bottom up Test ONLY
- Cannot be allocated on a reasonable and consistent basis
  – Perform Bottom up and Top Down Test BOTH

### Reversal of an Impairment Loss for Goodwill

Impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

- The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and
- Subsequent external events have occurred that reverse the effect of that event.

**Cash Generating Unit (CGU):** A CGU is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

### Recoverable Amount and Carrying Amount of a CGU

- Carrying amount is the summation of the carrying amount of all the assets grouped under one CGU.
- In this case, the net selling price of the CGU is the estimated selling price for the assets of the CGU and the liability together, less the costs of disposal.
- the recoverable amount of a CGU is sometimes determined after consideration of assets that are not part of the CGU or liabilities that have already been recognised in the financial statements.

### Impairment Loss for a CGU

The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order- First, to goodwill allocated to the CGU (if any); and then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets

**The carrying amount of an asset should not be reduced below the highest of:**

- Its net selling price (if determinable);
- Its value in use (if determinable); and
- Zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

After the requirements of impairment loss have been applied, a liability should be recognised for any remaining amount of an impairment loss for a CGU if that is required by another Accounting Standard.

### Reversal of an Impairment Loss for a CGU

- First, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and Then, to goodwill allocated to the CGU (if any),
- In allocating a reversal of an impairment loss for a CGU under paragraph 106, the carrying amount of an asset should not be increased above the lower of:
  - its recoverable amount (if determinable); and
  - the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.
- The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis

### Disclosures

- The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;
- The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;
- The amount of impairment losses recognised directly against revaluation surplus during the period; and
- The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

## Question & Answers

### Question 1

**A publisher owns 150 magazine titles of which 70 were purchased and 80 were self - created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment. What is the cash-generating unit as per AS 28? *(RTP May 20, Sep'24, New SM)***

**Answer 1**

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent one from another and that each magazine title is a separate cash-generating unit.

### Question 2

**M Ltd. produces a single product and owns plants A, B and C. Each plant is located in a different continent. Plant A produces a component that is assembled in either plant B or plant C. The combined capacity of plants B and C is not fully utilised. M Ltd's products are sold world-wide from either plants B or C i.e. plant B₹s production can be sold in plant C's continent if the products can be delivered faster from plant B than from plant C. Utilisation levels of plant B and plant C depend on the allocation of sales between the two sites.**

**For each of the following cases, what are the cash-generating units for plants A, B and C?**

**Case 1: There is an active market for plant A's products.**

**Case 2: There is no active market for plant A's products. *(RTP May 18)***

**Answer 2**

**Case 1:** It is likely that A is a separate cash-generating unit because there is an active market for its products. Although there is an active market for the products assembled by B and C, cashinflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually. Therefore, it is likely that B and C together is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent.

In determining the value in use of A and B plus C, M Ltd. adjusts financial budgets/forecasts to reflect its best estimate of future market prices for A's products.

**Case 2:** It is likely that the recoverable amount of each plant cannot be assessed independently because:

(a) there is no active market for A's products. Therefore, A's cash inflows dependon sales of the final product by B and C; and

(b) although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually.

As a consequence, it is likely that A, B and C together (i.e., M Ltd. as a whole) is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent.

### Question 3

**Wow Ltd. is developing a new production process. During the financial year ending 31st March, 2018, the total expenditure incurred was Rs. 50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2017. Expenditure incurred till this date was Rs.22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2019 was Rs. 80 lakhs. As at 31st March, 2019, the recoverable amount of know-how embodied in the process is estimated to be Rs. 72 lakhs. This includes estimates of future cash outflows as well as inflows.**

**You are required to calculate:**

i. **Amount to be charged to Profit and Loss A/c for the year ending 31st March, 2018 and carrying value of intangible as on that date.**
ii. **Amount to be charged to Profit and Loss A/c and carrying value of intangible as on 31st March, 2019. Ignore depreciation.** ***(MTP, 4 Marks Oct 18 )***

**Answer 3**

**As per AS 26 'Intangible Assets'**

**(i)** For the year ending 31.03.2018

(1) Carrying value of intangible as on 31.03.2018:

At the end of financial year 31st March 2018, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of Rs. 28 lakhs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st December 2017).

(2) Expenditure to be charged to Profit and Loss account:

The Rs. 22 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2018. This expenditure will not form part of the cost of the production process recognized in the balance sheet.

**(ii)** For the year ending 31.03.2019

(1) **Expenditure to be charged to Profit and Loss account:**

| | (Rs. in lakhs) |
|---|---|
| Carrying Amount as on 31.03.2018 | 28 |
| Expenditure during 2018 –2019 | 80 |
| Total book cost | 108 |
| Recoverable Amount | (72) |
| Impairment loss | 36 |

Rs. 36 lakhs to be charged to Profit and loss account for the year ending 31.03.2019.

(2) **Carrying value of intangible as on 31.03.2019:**

| | (Rs.in lakhs) |
|---|---|
| Total Book Cost | 108 |
| *Less:* Impairment loss | (36) |
| Carrying amount as on 31.03.2019 | 72 |

## Question 4

**Wiwitzu Ltd. purchased a Property, Plant and Equipment four years ago for ₹ 150 lakhs and depreciates it at 10% p.a. on straight line method. At the end of the fourth year, it has revalued the asset at ₹ 75 lakhs and has written off the loss on revaluation to the profit and loss account. However, on the date of revaluation, the market price is ₹ 67.50 lakhs and expected disposal costs are ₹ 3 lakhs. What will be the treatment in respect of impairment loss on the basis that fair value for revaluation purpose is determined by market value and the value in use is estimated at ₹ 60 lakhs?** ***(MTP 4 Marks Mar'24)(SM)***

**Answer 4**

**Treatment of Impairment Loss**

As per AS 28 "Impairment of assets", if the recoverable amount (higher of net selling price and its value in use) of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. In the given case, net selling price is ₹ 64.50 lakhs (₹ 67.50 lakhs – ₹ 3 lakhs) and value in use is ₹ 60 lakhs. Therefore, recoverable amount will be ₹ 64.50 lakhs. Impairment loss will be calculated as ₹ 10.50 lakhs [₹ 75 lakhs (Carrying Amount after revaluation - Refer Working Note) less ₹ 64.50 lakhs (Recoverable Amount)]. Thus impairment loss of ₹ 10.50 lakhs should be recognised as an expense in the Statement of Profit and Loss immediately since there was downward revaluation of asset which was already charged to Statement of Profit and Loss.

**Working Note:**

**Calculation of carrying amount of the Property, Plant and Equipment at the end of the fourth year on revaluation**

| (₹ in lakhs) | |
|---|---|
| Purchase price of a Property, Plant and Equipment | 150.00 |
| Less: Depreciation for four years [(150 lakhs / 10 years) x 4 years] | (60.00) |
| Carrying value at the end of fourth year | 90.00 |
| Less: Downward revaluation charged to profit and loss account | (15.00) |
| Revalued carrying amount | 75.00 |

## Question 5

**G Ltd., acquired a machine on 1st April, 20X0 for ₹ 7 crore that had an estimated useful life of 7 years. The machine is depreciated on straight line basis and does not carry any residual value. On 1st April, 20X4, the carrying value of the machine was reassessed at ₹ 5.10 crore and the surplus arising out of the revaluation being credited to revaluation reserve. For the year ended March, 20X6, conditions indicating an impairment of the machine existed and the amount recoverable ascertained to be only ₹ 79 lakhs. You are required to calculate the loss on impairment of the machine and show how this loss is to be treated in the books of G Ltd. G Ltd., had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.** ***(SM) (PYP 5 Marks May '18 ) (MTP 4 Marks Oct '17)***

**Answer 5**

**Statement Showing Impairment Loss**

| (₹ in crores) | | |
|---|---|---|
| Carrying amount of the machine as on 1st April, 20X0 | | 7.00 |
| Depreciation for 4 years i.e. 20X0-20X1 to 20X3-20X $\left[\frac{7\ Crores}{7\ Years} \times 4\ years\right]$ | | (4.00) |
| Carrying amount as on 31.03.20X4 | | 3.00 |
| *Add*: Upward Revaluation (credited to Revaluation Reserveaccount) | | 2.10 |
| Carrying amount of the machine as on 1st April, 20X4 (revalued) | | 5.10 |
| *Less*: Depreciation for 2 years i.e. 20X4-20X5& 20X5-20X6 $\left[\frac{5.10\ Crores}{3\ Years} \times 4\ years\right]$ | | (3.40) |
| Carrying amount as on 31.03.20X6 | | 1.70 |
| *Less*: Recoverable amount | | (0.79) |
| Impairment loss | | 0.91 |
| *Less*: Balance in revaluation reserve as on 31.03.20X6: | | |
| Balance in revaluation reserve as on 31.03.20X4 | | 2.10 |
| *Less*: Enhanced depreciation met from revaluation reserve | | |
| 20X4-20X5 & 20X5-20X6=[(1.70 – 1.00) x 2 years] | (1.40) | |
| Impairment loss set off against revaluation reserve balance as per para 58 of AS 28 "Impairment of Assets" | | (0.70) |
| Impairment Loss to be debited to profit and loss account | | 0.21 |

## Question 6

LDR

**A plant was acquired 15 years ago at a cost of ₹ 5 crores. Its accumulated depreciation as at 31st March, 20X1 was ₹ 4.15 crores. Depreciation estimated for the financial year 20X1-20X2 is ₹ 25 lakhs. Estimated Net Selling Price as on 31st March, 20X1 was ₹ 30 lakhs, which is expected to decline by 20 per cent by the end of the next financial year.**

**Its value in use has been computed at ₹ 35 lakhs as on 1st April, 20X1, which is expected to decrease by 30 per cent by the end of the financial year.**

**(i) Assuming that other conditions for applicability of the impairment Accounting Standard are satisfied,**

what should be the carrying amount of this plant as at 31st March, 20X2?

(ii) How much will be the amount of write off for the financial year ended 31st March, 20X2?

(iii) If the plant had been revalued ten years ago and the current revaluation reserves against this plant were to be ₹ 12 lakhs, how would you answer to questions (i) and (ii) above?

If the value in use was zero and the enterprise were required to incur a cost of ₹ 2 lakhs to dispose of the plant, what would be your response to questions (i) and (ii) above? (SM)

**Answer 6**

As per AS 28 "Impairment of Assets", if the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount and that reduction is an impairment loss. An impairment loss on a revalued asset is recognized as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

In the given case, recoverable amount (higher of asset's net selling price and value in use) will be ₹ 24.5 lakhs on 31.3.20X2 according to the provisions of AS 28 [Refer working note].

| | | |
|---|---|---|
| | | **(₹ in lakhs)** |
| (i) | Carrying amount of plant (after impairment) as on 31st March, 20X2 | 24.50 |
| (ii) | Amount of write off (impairment loss) for the financial year ended 31st March, 20X2 [₹ 60 lakhs – ₹ 24.5 lakhs] | 35.50 |
| (iii) | If the plant had been revalued ten years ago | |
| | Debit to revaluation reserve | 12.00 |
| | Amount charged to profit and loss account (₹ 35.50 lakhs – ₹ 12 lakhs) | 23.50 |
| (iv) | If Value in use is zero | |
| | Value in use (a) | Nil |
| | Net selling price (b) | (-)2.00 |
| | Recoverable amount [higher of (a) and (b)] | Nil |
| | Carrying amount (closing book value) | Nil |
| | Amount of write off (impairment loss) (₹ 60 lakhs – Nil) | 60.00 |
| | Entire book value of plant will be written off and charged to profit and loss account. | |

**Working Note:**

**Calculation of Closing Book Value, Estimated Net Selling Value andEstimated Value in Use of Plant at 31st March, 20X2**

| | **(₹ in lakhs)** |
|---|---|
| Opening book value as on 1.4.20X1 (₹ 500 lakhs – ₹ 415 lakhs) | 85 |
| **Less:** Depreciation for financial year 20X1–20X2 | (25) |
| Closing book value as on 31.3.20X2 | 60 |
| Estimated net selling price as on 1.4.20X1 | 30 |
| **Less:** Estimated decrease during the year (20% of ₹ 30 lakhs) | (6) |
| Estimated net selling price as on 31.3.20X2 | 24 |
| Estimated value in use as on 1.4.20X1 | 35.0 |
| **Less:** Estimated decrease during the year (30% of ₹ 35 lakhs) | (10.5) |
| Estimated value in use as on 31.3.20X2 | 24.5 |

## Question 7

**Himalaya Ltd. which is in a business of manufacturing and export of its product. Sometimes, back in 2014, the Government put restriction on export of goods exported by Himalaya Ltd. and due to that restriction Himalaya Ltd. impaired its assets. Himalaya Ltd. acquired identifiable assets worth of ₹ 4,000 lakhs for ₹ 6,000 lakh at the end of the year 2010. The difference is treated as goodwill. The useful life of identifiable assets is 15 years and depreciated on straight line basis. When Government put the restriction at the end of 2014, the company recognised the impairment loss by determining the recoverable amount of assets for ₹ 2,720 lakh.**

In 2016 Government lifted the restriction imposed on the export and due to this favourable change, Himalaya Ltd. re-estimate recoverable amount, which was estimated at ₹ 3,420 lakh.

**Required:**

(i) Calculation and allocation of impairment loss in 2014.

(ii) Reversal of impairment loss and its allocation as per AS 28 in 2016. *(PYP Nov 17)*

**Answer 7**

**Calculation and allocation of impairment loss in 2014 (Amount in ₹ lakhs)**

| | Goodwill | Identifiable assets | Total |
|---|---|---|---|
| Historical cost | 2,000 | 4,000 | 6,000 |
| Accumulated depreciation/amortization (4 yrs.) | (1,600) | (1,067) | (2,667) |
| Carrying amount before impairment | 400 | 2,933 | 3,333 |
| Impairment loss* | (400) | (213) | (613) |
| Carrying amount after impairment loss | 0 | 2,720 | 2,720 |

* Notes:

1. As per para 87 of AS 28, an impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:
   (a) first, to goodwill allocated to the cash-generating unit (if any); and
   (b) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

   Hence, first goodwill is impaired at full value and then identifiable assets are impaired to arrive at recoverable value.
2. Since the goodwill has arisen on acquisition of assets, AS 14 comes into the picture. As per para 19 of AS 14, goodwill shall amortise over a period not exceeding five years unless a somewhat longer period can be justified. Therefore, the amortization period of goodwill is considered as 5 years.

**Carrying amount of the assets at the end of 2016(Amount in ₹ lakhs)**

| End of 2016 | Goodwill | Identifiable assets | Total |
|---|---|---|---|
| Carrying amount in 2016 | 0 | 2,225 | 2,225 |
| Add: Reversal of impairment loss (W.N.2) | - | 175 | 175 |
| Carrying amount after reversal of impairment loss | - | 2,400 | 2,400 |

**Working Note:**

**Calculation of depreciation after impairment till 2016 and reversal of impairment loss in 2016**

| (Amount in ₹ | | | lakhs) |
|---|---|---|---|
| | **Goodwill** | **Identifiable assets** | **Total** |
| Carrying amount after impairment loss in 2014 | 0 | 2,720 | 2,720 |
| Additional depreciation (i.e. (2,720/11) x 2) | – | (495) | (495) |
| Carrying amount | 0 | 2,225 | 2,225 |
| Recoverable amount | | | 3,420 |
| Excess of recoverable amount over carrying amount | | | 1,195 |

**Note:** It is assumed that the restriction by the Government has been lifted atthe end of the year 2016.

**Determination of the amount to be impaired by calculating depreciated historical cost of the identifiable assets without impairment at the end of 2016**

| End of 2016 | Identifiable assets |
|---|---|
| Historical cost | 4,000 |
| Accumulated depreciation | (266.67 x 6 years) = (1,600) |
| Depreciated historical cost | 2,400 |
| Carrying amount (in W.N. 1) | 2,225 |
| Amount of reversal of impairment loss | 175 |

**Notes:**

1. As per para 107 of AS 28, in allocating a reversal of an impairment loss for a cash-generating unit, the carrying amount of an asset should not be increased above the lower of:
   (a) its recoverable amount (if determinable); and
   (b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognized for the asset in prior accounting periods.
   Hence impairment loss reversal is restricted to ₹175 lakhs only.
2. The reversal of impairment loss took place in the 6th year. However, goodwill is amortised in 5 years. Therefore, there would be no balance inthe goodwill account in the 6th year even without impairment loss. Hencein W.N. 2 above there is no column for recalculation of goodwill.

## Question 8

**H Ltd. which is in a business of manufacturing and export of its product. Sometimes, back in 2018, the Government put restriction on export of goods exported by H Ltd. and due to that restriction H Ltd. impaired its assets. H Ltd. acquired identifiable assets worth of Rs. 4,000 lakh for Rs. 6,000 lakh at the end of the year 2014. The difference is treated as goodwill. The useful life of identifiable assets is 15 years and depreciated on straight line basis. When Government put the restriction at the end of 2018, the company recognised the impairment loss by determining the recoverable amount of assets for Rs. 2,720 lakh. In 2020 Government lifted the restriction imposed on the export and due to this favourable change, H Ltd. re-estimate recoverable amount, which was estimated at Rs. 3,420 lakh.**

**Required:**

**(i) Calculation and allocation of impairment loss in 2018.**

**(ii) Reversal of impairment loss and its allocation as per AS 28 in 2020.** ***(RTP Nov 20)***

**Answer 8**

**(i) Calculation and allocation of impairment loss in 2018(Amount in Rs. lakh)**

| | Goodwill | Identifiable assets | Total |
|---|---|---|---|
| Historical cost | 2,000 | 4,000 | 6,000 |
| Accumulated depreciation/amortization (4 yrs.) | (1,600) | (1,067) | (2,667) |
| Carrying amount before impairment | 400 | 2,933 | 3,333 |
| Impairment loss* | (400) | (213) | (613) |
| Carrying amount after impairment loss | 0 | 2,720 | 2,720 |

**Notes:**

1. As per para 87 of AS 28, an impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:
   (a) first, to goodwill allocated to the cash-generating unit (if any); and
   (b) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.Hence, first goodwill is impaired at full value and then identifiable assets are impaired to arrive at recoverable value.
2. Since the goodwill has arisen on acquisition of assets, AS 14 comes into the picture. As per para 19 of AS 14, goodwill shall amortise over a period not exceeding five years unless a somewhat longer period can be justified. Therefore, the amortization period of goodwill is considered as 5 years.

**(ii) Carrying amount of the assets at the end of 2020 (Amount in Rs. lakh)**

| End of 2020 | Goodwill | Identifiable assets | Total |
|---|---|---|---|
| Carrying amount in 2020 | 0 | 2,225 | 2,225 |
| Add: Reversal of impairment loss (W.N.2) | - | 175 | 175 |
| Carrying **amount** after reversal of impairment loss | - | 2,400 | 2,400 |

**Working Note:**

**1. Calculation of depreciation after impairment till 2020 and reversal of impairment loss in 2020**

| (Amount in Rs. lakh) | | | |
|---|---|---|---|
| | Goodwill | Identifiable assets | Total |
| Carrying amount after impairment loss in 2018 | 0 | 2,720 | 2,720 |
| Additional depreciation (i.e. (2,720/11) x 2) | – | (495) | (495) |
| Carrying amount | 0 | 2,225 | 2,225 |
| Recoverable amount | | | 3,420 |
| Excess of recoverable amount over carrying amount | | | 1,195 |

**Note:** It is assumed that the restriction by the Government has been lifted at the end of the year 2020.

**2. Determination of the amount to be impaired by calculating depreciated historical cost of the identifiable assets without impairment at the end of 2020 (Amount in Rs. lakh)**

| End of 2020 | Identifiable assets |
|---|---|
| Historical cost | 4,000 |
| Accumulated depreciation | (266.67 x 6 years) = (1,600) |
| Depreciated historical cost | 2,400 |
| Carrying amount (in W.N.1) | 2,225 |
| Amount of reversal of impairment loss | 175 |

**Notes:**

1. As per para 107 of AS 28, in allocating a reversal of an impairment loss for a cash-generating unit, the carrying amount of an asset should not be increased above the lower of:
   (a) its recoverable amount (if determinable); and
   (b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.
   Hence impairment loss reversal is restricted to Rs. 175 lakh only.
2. The reversal of impairment loss took place in the 6th year. However, goodwill is amortised in 5 years. Therefore, there would be no balance in the goodwill account in the 6th year even without impairment loss. Hence in W.N. 2 above there is no column for recalculation of goodwill.

## Question 9

**C Ltd. acquired S Ltd. business (a cash generating unit) on 31-3-2016 for ₹ 8,000 Lakhs. The details of acquisition are us under: -**

| | |
|---|---|
| Fair value of identifiable asset | 6000 Lakhs |
| Goodwill | 2000 Lakhs |

**The anticipated useful life of acquired assets is 5 years Goodwill is to be amortised in 4 years C Ltd. uses straight-line method of depreciation with no residual values anticipated. On 31-3-2018, C Ltd. estimated the significant decline in production due to change in Government policies. The net selling price of identifiable asset is not determinable. The cash flow forecast based on recent financial budget for next 7 years after considering change in Govt. policies are as follows. Incremental financing cost is 8% which represent current market assessment of the time value of money.**

| | | | ₹ in Crore |
|---|---|---|---|
| Year | Cash flow | Year | Cash flow |
| 2019 | 800 | 2022 | 600 |
| 2020 | 800 | 2023 | 600 |
| 2021 | 800 | 2024 | 500 |
| | | 2025 | 400 |

**You are required to calculate:**

**(i) Value in use**

**(ii) Impairment loss**

**(iii) Revised carrying amount on 31-3-2018** ***(PYP Nov 18 5 Marks)***

**Answer 9**

**(i) Value in Use**

| Year ended on 31st March | Cash flow (₹ in lakh) | Discounting factor @ 8% | Present Value (₹ in lakh) |
|---|---|---|---|
| 2019 | 800 | 0.926 | 740.80 |
| 2020 | 800 | 0.857 | 685.60 |
| 2021 | 800 | 0.794 | 635.20 |
| 2022 | 600 | 0.735 | 441.00 |
| 2023 | 600 | 0.681 | 408.60 |
| 2024 | 500 | 0.630 | 315.00 |
| 2025 | 400 | 0.583 | 233.20 |
| | | | 3459.40 |

**Impairment loss**

Impairment loss = Carrying amount of the asset - Recoverable Amount

= ₹ 4,600 lakhs - ₹ 3,459.40 lakhs (Refer W.N.)

= ₹ 1,140.60 lakhs

**Revised Carrying Amount on 31.3.2018**

As per para 87 of AS 28 'Impairment of Assets', an impairment loss should be allocated to reduce the carrying amount of the assets of CGU in the following order:

(a) first, to goodwill allocated to the cash-generating unit (if any); and

(b) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

Hence, first goodwill is impaired at full value and then identifiable assets are impaired to arrive at recoverable value. (₹ in lakh)

| | Goodwill | Identifiable assets | Total |
|---|---|---|---|
| Useful life | 4 years | 5 years | |
| Historical cost | 2,000 | 6,000 | 8,000 |
| Accumulated depreciation/amortization (for 2 years) | (1,000) | (2,400) | (3,400) |
| Carrying amount before impairment | 1,000 | 3,600 | 4,600 |
| Impairment loss | (1,000) | (140.60) | (1,140.60) |
| Revised carrying amount after impairment loss | 0 | 3,459.40 | 3,459.40 |

**Working Note:**

Calculation of Recoverable Amount

Recoverable amount = Higher of Asset's Net Selling Price or Value in Use

Where, Asset's net selling price is not determinable

Recoverable Amount of the asset will be equal to the Value in use ie. ₹ 3,459.40 lakh.

## Question 10

**M Ltd. has three cash-generating units: A, B and C. Due to adverse changes in the technological environment, M Ltd. conducted impairment tests of each of its cash- generating units. On 31st March, 2018, the carrying amounts of A, B and C are Rs. 100 lakhs, Rs. 150 lakhs and Rs. 200 lakhs respectively.**

**The operations are conducted from a headquarter. The carrying amount of the headquarter assets is Rs. 200 lakhs: a headquarter building of Rs. 150 lakhs and a research centre of Rs. 50 lakhs. The relative carrying amounts of the cash-generating units are a reasonable indication of the proportion of the head-quarter building devoted to each cash-generating unit. The carrying amount of the research centre cannot be allocated on a reasonable basis to the individual cash-generating units.**

**Following is the remaining estimated useful life of:**

| | A | B | C | Head quarter assets |
|---|---|---|---|---|
| Remaining estimated useful life | 10 | 20 | 20 | 20 |

The headquarter assets are depreciated on a straight-line basis.

The recoverable amount of each cash generating unit is based on its value in use since net selling price for each CGU cannot be calculated. Therefore, Value in use is equal to

| | | | | as a whole |
|---|---|---|---|---|
| erable amount | | | | |

*The research centre generates additional future cash flows for the enterprise as a whole. Therefore, the sum of the value in use of each individual CGU is less than the value in use of the business as a whole. The additional cash flows are not attributable to the headquarter building.

Calculate and show allocation of impairment loss as per AS 28. Ignore tax effects. *(RTP Nov 18)*

**Answer 10**

1. **Identification of Corporate Assets of M Ltd.**

   Here, the corporate assets are the headquarter building and the research centre.

   For corporate building

   Since, the carrying amount of the headquarter building can be allocated on a reasonable and consistent basis to the cash-generating units under review. Therefore, only a ₹bottom-up₹ test is necessary.

   For research centre

   Since the carrying amount of the research centre cannot be allocated on a reasonable and consistent basis to the individual CGU under review. Therefore, a ₹top-down₹ test will be applied in addition to the ₹bottom-up₹ test.

2. **Allocation of Corporate Assets**

   Since the estimated remaining useful life of A₹s CGU is 10 years, whereas the estimated remaining useful lives of B and C₹s CGU are 20 years, the carrying amount of the headquarter building is allocated to the carrying amount of each individual cash-generating unit on weight basis.

3. **Calculation of a weighted allocation of the carrying amount of the headquarter building (Amount in Rs. lakhs)**

| On 31st March, 2018 | A | B | C | Total |
|---|---|---|---|---|
| Carrying amount **(A)** | 100 | 150 | 200 | 450 |
| Useful life | 10 years | 20 years | 20 years | |
| Weight based on useful life | 1 | 2 | 2 | |
| Carrying amount after weight | 100 | 300 | 400 | 800 |
| Pro-rata allocation of the building | 12.5% | 37.5% | 50% | 100% |
| | (100/800) | (300/800) | (400/800) | |
| Allocation of the carrying amount of thebuilding (based on pro-rata above) **(B)** | 18.75 | 56.25 | 75 | 150 |
| Carrying amount (after allocation of thebuilding) | 118.75 | 206.25 | 275 | 600 |

4. **Calculation of Impairment LossesApplication of ₹bottom-up₹ test (Amount in Rs. lakhs)**

| 31st March, 2018 | A | B | C |
|---|---|---|---|
| Carrying amount (after allocation of the building)(Refer point 3 above) | 118.75 | 206.25 | 275 |
| Recoverable amount (given in the question) | 199 | 164 | 271 |
| Impairment loss | 0 | (42) | (4) |

**Allocation of the impairment losses for cash-generating units B and C (Amount in Rs. lakhs)**

| Cash-generating unit | B | C |
|---|---|---|
| To headquarter building | (12) (42*56/206) | (1) (4*75/275) |
| To assets in cash-generating unit | (30) (42*150/206) | (3) (4*200/275) |
| | (42) | (4) |

Since the research centre could not be allocated on a reasonable and consistent basis to A, B and C₹s CGU, M Ltd. compares the carrying amount of the smallest CGU to which the carrying amount of the research centre can be allocated (i.e., M as a whole) to its recoverable amount, in accordance with the ₹top-down₹ test.

**Application of the ₹top-down₹ test (Amount in Rs. lakhs)**

| 31st March, 2018 | A | B | C | Building | Research Centre | M Ltd. |
|---|---|---|---|---|---|---|
| Carrying amount | 100 | 150 | 200 | 150 | 50 | 650 |
| Impairment loss arising from the ₹bottom-up₹ test | – | (30) | (3) | (13) | – | (46) |
| Carrying amount after the ₹bottom-up₹ test | 100 | 120 | 197 | 137 | 50 | 604 |
| Recoverable amount | | | | | | 720 |

Since recoverable amount is more than the carrying amount of M Ltd., no additional impairment loss has been resulted from the application of the top- down test. Only an impairment loss of Rs. 46 lakhs will be recognized as a result of the application of the ₹bottom-up₹ test.

**Multiple Choice Questions (MCQs)**

1. **If there is indication that an asset may be impaired but the recoverable amount of the asset is more than the carrying amount of the asset, the following are true:** ***(SM)***
   (a) No further action is required and the company can continue the asset in the books at the book value itself.
   (b) The entity should review the remaining useful life, scrap value and method of depreciation and amortization for the purposes of AS 10.
   (c) The entity can follow either (a) or (b).
   (d) The entity should review the scrap value and method of depreciation and amortization for the purposes of AS 10.

**Ans: (b)**

2. **In case Goodwill appears in the Balance Sheet of an entity, the following is true:** ***(SM)***
   (a) Apply Bottom up test if goodwill cannot be allocated to CGU (cash generating unit) under review.
   (b) Apply Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
   (c) Apply both Bottom up test and Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
   (d) Apply either Bottom up test or Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.

**Ans: (c)**

3. **In case of Corporate assets in the Balance Sheet of an entity, the following is true:** ***(SM)***
   (a) Apply Bottom up test if corporate assets cannot be allocated to CGU (cash generating unit) under review.
   (b) Apply Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.
   (c) Apply both Bottom up test and Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.
   (d) Apply either Bottom up test or Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.

**Ans: (c)**

4. **In case of reversal of impairment loss, which statement is true:** ***(SM)***
   (a) Goodwill written off can never be reversed.
   (b) Goodwill written off can be reversed without any conditions to be met.
   (c) Goodwill written off can be reversed only if certain conditions are met.
   (d) Goodwill written off can be reversed.

**Ans: (c)**

B

# CHAPTER 6.1: AS 15 EMPLOYEE BENEFITS

**CONCEPTS OF THIS CHAPTER**

- Employee Benefits
- Short-term Employee Benefits
- Defined contribution
- Actuarial Valuation
- Measure Post-employment Obligations
- Gains/Losses on Curtailment or Settlement
- Post-employment Benefits
- Defined Contribution Plans
- Defined benefit
- Actuarial Gains/Losses
- Disclosure Requirements
- Long-term and Termination Benefits
- Recognize and Measure Short-term Benefits
- Short-term Compensated Absences & Profit-sharing/Bonus

**LDR Questions**
**Q 9**

## QUICK REVIEW OF IMPORTANT CONCEPTS



**Short Term Employee Benefits-** Short-term employee benefits (other than termination benefits) are payable within twelve months after the end of the period in which the service is rendered. No actuarial assumptions are required to measure the obligation or cost.

Short-term employee benefits are broadly classified into four categories:

i. Regular period benefits (e.g., wages, salaries);
ii. Short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);
iii. Profit sharing and bonuses payable within twelve months after the end of the period in which employee render the related services and
iv. Non-monetary benefits (e.g., medical care, housing, cars etc.)

### Post Employment Benefits: Defined Contribution Vs Defined Benefits

**Defined contribution plans** require fixed contributions to a separate fund, with no further obligation for the enterprise. The employee bears actuarial and investment risks. A common example is the Provident Fund.

**Defined benefit plans** are post-employment benefit plans other than defined contribution plans. In defined benefits plans, the actuarial and investment risk fall on the employer

**Accounting Treatment**

In the Balance Sheet of the enterprise, the amount recognized as a defined benefit liability should be the net total of the following amounts:

- the PV of the defined benefit obligation at the balance sheet date;
- minus any past service cost not yet recognized;
- minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.

If fair value of plan assets is high, it may so happen that the net under defined benefit liability turns negative (giving rise to net assets). measure the resulting asset at the lower of:

- the amount so determined; and
- the PV of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan

The Standard identifies seven components of defined employee benefit costs:

- Current service cost;

- Interest cost;
- The expected return on any plan assets (and on any reimbursement rights);
- Actuarial gains and losses (to the extent they are recognized);
- Past service cost (to the extent they are recognized);
- The effect of any curtailments or settlements; and
- The extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(b) of the Standard.

**Actuarial Assumptions:** Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense.

**Other Long Term Employee Benefits**

Other long-term employee benefits include, for example:

- long-term compensated absences such as long-service or sabbatical leave;
- jubilee or other long-service benefits;
- long-term disability benefits;
- profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and
- deferred compensation paid twelve months or more after the end of the period in which it is earned.

**Termination Benefits**

- Termination benefits are recognized as a liability and expense only with an approved formal plan and a reliable cost estimate.
- Benefits due within 12 months are recorded at an undiscounted amount in the balance sheet and charged to P&L.
- Benefits due after 12 months are discounted using an appropriate rate.
- If uncertainty exists about employee acceptance of voluntary redundancy, it is disclosed as a contingent liability under AS 29.

<u>**Question & Answers**</u>

**Question 1**

**Hello Limited belongs to the manufacturing industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 12 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 4 lakhs instead of ₹ 10 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalization of accounts, taking note of the mandatory accounting standards.** ***(RTP May'24) (Same Concept Different figure MTP May 20 ,RTP May 18 & RTP Nov 19)***

**Answer 1**

According to AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 12 lakhs is required to be credited to the profit and loss statement of the current year.

**Question 2**

**Synergy Ltd. is in engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employee is estimated to be 6 years. You are required to advise the company.** ***(MTP 4 Marks July'24)***

**Answer 2**

According to AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of ₹ 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year. Hence, Synergy Ltd. cannot spread the actuarial gain of ₹ 6 lakhs over the next 2 years by reducing the annual contributions to ₹ 2 lakhs instead of ₹ 5 lakhs. It has to contribute ₹ 5 lakhs annually for its pension schemes.

## Question 3

**What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS 15? *(SM)***

**Answer 3**

There are four types of employee benefits according to AS 15 (Revised 2005). They are:

(a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company byan employer to pay for medical care of its employees), paid annualleave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medicalcare, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employmentmedical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Statement establishes separate requirements for each category.

The objective of AS 15 is to prescribe the accounting and disclosure for employee benefits. The statement requires an enterprise to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange foremployee benefits.

## Question 4

**Luv limited is a private Limited company. As per HR policy of Luv Limited, Grade F employees are eligible for sabbatical leave (Long term compensated absences as per AS 15). Till previous year, there were 15 employees who are eligible for Sabbatical leave and company had duly recorded the liability for long term compensated absences based on the actuarial valuation for eligible employees. During the current period out of total 15 employees, 13 employees have left the organization and only 2 employees are continuing in LUV Limited. Due to budget constraint, CFO has denied to involve actuary and told finance manager to determine the liability based on the recent actuarial report available with them. Finance manager ensured the following:**

**- There is no material change in interest rate**

**- There is no change in fair value of plan assets.**

**Based on that, Finance manager have manually computed an amount of Rs. 5,00,000 (considering last year actuarial report as base) towards long term compensation liability without involving Actuary during the period ended 31.03.2020. Is this treatment is in line with AS 15? *(RTP Nov 20)***

**Answer 4**

As per para 58 of the AS 15, the detailed actuarial valuation of the present value of defined benefit obligations may be made at intervals not exceeding three years. However, with a view that the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date, the most recent valuation is reviewed at the balance sheet date and updated to reflect any material transactions and other material changes in circumstances (including changes in interest rates) between the date of valuation and the balance sheet date. The fair value of any plan assets is determined at each balance sheet.

Since AS-15 (Para 58) states that actuarial valuation needs to be done at least once in three years. Since management had done the actuarial valuation in Previous Year, they can go ahead with exemption for this year subject to evaluation and conclusion by management as at balance sheet date that there are no significant changes in the amount of liability compared to previous year. Hence working done by the finance manager is appropriate. It is in line with AS 15, since company had recently done the actuarial valuation in previous year and there is no material changes in the external environment.

## Question 5

**A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively, employees can claim a lump sum amount equal to one month pay last drawn.**

**The company's contentions in this matter are:**

**(i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.**

**(ii) Since it is not related to the length of service of the employees, it is accounted for on claim basis.**

**State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.** ***(MTP 5 Marks Aug 18, RTP May'17, SM)***

**Answer 5**

The present case falls under the category of defined benefit scheme under Para 49 of AS 15 "Employee Benefits". The said para encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15.

(2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

## Question 6

**The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.20X2 calculate the actual return on plan assets: (SM)**

| | |
|---|---:|
| **- Benefits paid** | **2,00,000** |
| **- Employer contribution** | **2,80,000** |
| **- Fair market value of plan assets on 31.03.20X2** | **11,40,000** |
| **- Fair market value of plan assets as on 31.03.20X1** | **8,00,000** |

**Answer 6**

| | ₹ |
|---|---:|
| Fair value of plan assets on 31.3.20X1 | 8,00,000 |
| Add: Employer contribution | 2,80,000 |
| Less: Benefits paid | (2,00,000) |
| (A) | 8,80,000 |
| Fair market value of plan assets at 31.3.20X2 (B) | 11,40,000 |
| Actual return on plan assets (B-A) | 2,60,000 |

## Question 7

**The fair value of plan assets of Viwit Su Ltd. was ₹ 2,00,000 in respect of employee benefit pension plan as on 1st April, 20X1. On 30th September, 20X1 the plan paid out benefits of ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 20X2 the fair value of plan assets was ₹ 3,00,000. On 1st April, 20X1 the company made the following estimates, based on its market studies and prevailing prices.**

| | % |
|---|---:|
| **Interest and dividend income (after tax) payable by fund** | **10.25** |
| **Realized gains on plan assets (after tax)** | **3.00** |
| **Fund administrative costs** | **(3.00)** |
| **Expected rate of return** | **10.25** |

**Calculate the expected and actual returns on plan assets as on 31st March,20X2, as per AS 15.(SM)**

**Answer 7**

**Computation of Expected Returns on Plan Assets as on 31st March, 20X2, asper AS 15**

| | ₹ |
|---|---|
| Return on opening value of plan assets of ₹ 2,00,000 (held for the year) @ 10.25% | 20,500 |
| Add: Return on net gain of ₹ 30,000 (i.e. ₹ 55,000 – ₹ 25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months) | 1,500 |
| Expected return on plan assets as on 31st March, 20X2 | 22,000 |

**Computation of Actual Returns on Plan Assets as on 31st March, 20X2, as per AS 15**

| | ₹ | ₹ |
|---|---|---|
| Fair value of Plan Assets as on 31st March, 20X2 | | 3,00,000 |
| Less: Fair value of Plan Assets as on 1st April 20X1 | (2,00,000) | |
| Add: Contribution received as on 30th September, 20X1 | 55,000 | (2,55,000) |
| | | 45,000 |
| Add: Benefits paid as on 30th September, 20X1 | | 25,000 |
| Actual reruns on Plan Assets as on 31st March, 20X2 | | 70,000 |

## Question 8

**Peter Ltd. discontinues a business segment. Under the agreement with employee₹s union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. If the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.**

**Peter Ltd. estimates the share of unamortized service cost that relates to the part of the obligation at Rs. 18 (10% of Rs. 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Peter Ltd. on the basis of given information:**

**(a) Immediately before the curtailment, gross obligation is estimated at Rs. 6,000 based on current actuarial assumption.**

**(b) The fair value of plan assets on the date is estimated at Rs. 5,100.**

**(c) The unamortized past service cost is Rs. 180.**

***(d)* Curtailment reduces the obligation by Rs. 600, which is 10% of the gross obligation. *(RTP May 19)( SM)(Same concept different figures MTP 5 Marks Mar'17)***

**Answer 8**

**Gain from curtailment is estimated as under:**

| | Rs. |
|---|---|
| Reduction in gross obligation | 600 |
| Less: Proportion of unamortised past service cost | (18) |
| Gain from curtailment | 582 |

The liability to be recognised after curtailment in the balance sheet is estimated as under:

| | Rs. |
|---|---|
| Reduced gross obligation (90% of Rs. 6,000) | 5,400 |
| Less: Fair value of plan assets | (5,100) |
| | 300 |
| Less: Unamortised past service cost (90% of Rs. 180) | (162) |
| Liability to be recognised in the balance sheet | 138 |

## Question 9

LDR

**Pendora Ltd. has given the following details in respect of employee benefit pension plan:**

| Particulars | Amount ₹ |
|---|---|
| The fair value of plan assets as on 01-04-2023 | 5,00,000 |
| The benefits paid out on 30-11-2023 | 63,000 |
| Inward contributions received on 30-09-2023 | 1,42,000 |
| The fair value of plan assets as on 31-03-2024 | 7,50,000 |

**On 01.04.2023, the company made following estimates, based on its market studies and prevailing prices :**

| Particulars | % |
|---|---|
| Interest and dividend income (after tax) payable by fund | 10.50 |
| Realised gains on plan assets (after tax) | 2.00 |
| Fund administrative costs | -2.00 |
| Expected rate of annual return (Interest is compounded annually) | 10.50 |

**You are required to find the expected and actual returns on plan assets as on 31.03.2024 as per AS 15. *(PYP 5 Marks Sep'24)***

**Answer 9**

**Computation of Expected and Actual Returns on Plan Assets**

| | | ₹ |
|---|---|---|
| Return on ₹ 5,00,000 held for 12 months at 10.50% | | 52,500 |
| Return on ₹ 1,42,000 for 6 months at 10.50% | | 7,455 |
| Loss of interest on benefits paid for 4 months on ₹ 63,000 for 4 months @ 10.50% | | (2,205) |
| Expected return on plan assets for 2023-2024 | | 57,750 |
| Fair value of plan assets as on 31st March 2024 | | 7,50,000 |
| *Less*: Fair value of plan assets as on 1 April,2023 | 5,00,000 | |
| Contributions received on 30.9.2023 | 1,42,000 | (6,42,000) |
| | | 1,08,000 |
| Add: Benefits paid on 30th Nov 2023 | | 63,000 |
| Actual return on plan assets | | 1,71,000 |

## Question 10

**An employee Roshan has joined a company XYZ Ltd. in the year 20X1. The annual emoluments of Roshan as decided is ₹ 14,90,210. The company also has a policy of giving a lump sum payment of 25% of the last drawn annual salary of the employee for each completed year of service if the employee retires after completing minimum 5 years of service. The salary of the Roshan is expected to grow @ 10% per annum.**

**The company has inducted Roshan in the beginning of the year and it is expected that he will complete the minimum five year term before retiring. Thus he will get 5 yearly increment.**

**What is the amount the company should charge in its Profit and Loss account every year as cost for the Defined Benefit obligation? Also calculate the current service cost and the interest cost to be charged per year assuming a discount rate of 8%. (P.V factor for 8% - 0.735, 0.794, 0.857, 0.926, 1) *(SM)***

**Answer 10**

**Calculation of Defined Benefit Obligation (DBO)**

Expected last drawn salary = ₹ 14,90,210 x 110% x 110% x 110% x 110% x 110%

= ₹ 24,00,000

Defined Benefit Obligation (DBO) = ₹ 24,00,000 x 25% x 5 = ₹ 30,00,000

Amount of ₹ 6,00,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

**Calculation of Current Service Cost**

| Year | Equal apportioned amount of DBO [i.e.₹ 30,00,000/5 years] | Discounting @ 8% PV factor | Current service cost (Present Value) |
|---|---|---|---|
| a | b | c | d = b x c |
| 1 | 6,00,000 | 0.735 (4 Years) | 4,41,000 |

| | | | |
|---|---|---|---|
| 2 | 6,00,000 | 0.794 (3 Years) | 4,76,400 |
| 3 | 6,00,000 | 0.857 (2 Years) | 5,14,200 |
| 4 | 6,00,000 | 0.926 (1 Year) | 5,55,600 |
| 5 | 6,00,000 | 1 (0 Year) | 6,00,000 |

**Calculation of Interest Cost to be charged per year**

| Year | Opening balance | Interest cost | Current service cost | Closing balance |
|---|---|---|---|---|
| a | b | c = b x 8% | d | e = b + c + d |
| 1 | 0 | 0 | 4,41,000 | 4,41,000 |
| 2 | 4,41,000 | 35,280 | 4,76,400 | 9,52,680 |
| 3 | 9,52,680 | 76,214 | 5,14,200 | 15,43,094 |
| 4 | 15,43,094 | 1,23,447 | 5,55,600 | 22,22,141 |
| 5 | 22,22,141 | 1,77,859* | 6,00,000 | 30,00,000 |

*Due to approximations used in calculation, this figure is adjusted accordingly.

## Multiple Choice Questions (MCQs)

**1. Gratuity and Pension would be examples of: *(SM)***

(a) Short-term employee benefits
(b) Long-term employee benefits
(c) Post-employment benefits.
(d) None of the above.

**Ans: (c)**

**2. Non-accumulating compensating absence is commonly referred to as: *(SM)***

(a) Earned Leave
(b) Sick Leave
(c) Casual leave
(d) All of the above

**Ans: (c)**

**3. The plans that are established by legislation to cover all enterprises and are operated by Governments include: *(SM)***

(a) Multi-Employer plans
(b) State plans
(c) Insured Benefits
(d) Employee benefit plan

**Ans: (b)**

**4. Best estimates of the variable to determine the eventual cost of post- employment benefits is referred to as: *(SM)***

(a) Employer's contribution
(b) Actuarial assumptions
(c) Cost to Company
(d) Employee's contribution

**Ans: (b)**

**5. Actuarial gains / losses should be: *(SM)***

(a) Recognized through reserves
(b) Charged over the expected life of employees
(c) Charged immediately to Profit and Loss Statement
(d) Do not charged to Profit and Loss Statement

**Ans: (c)**

# CHAPTER 6.2: AS–29 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

| CONCEPTS OF THIS CHAPTER | LDR Questions |
|---|---|
| • Executory Contracts<br>• Provision<br>• Liability<br>• Obligating Event<br>• Need for Provision Recognition<br>• Present Obligation and Past Event<br>• Probable Outflow of Resources<br>• Recognition and Measurement<br>• Disclosure Requirements | Q 12<br>Q 16 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Contingent Liability:**

(a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) A present obligation that arises from past events but is not recognised because-
- It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- A reliable estimate of the amount of the obligation cannot be made.

- An enterprise should not recognise a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.
- Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made

**Provisions**

A provision should be recognised when:
- An enterprise has a present obligation as a result of a past
- It is probable that an outflow of resources Embodying economic benefits will be required to settle the obligation;
- A reliable estimate can be made of the amount of the obligation.

**Present Obligation**
- An enterprise assesses all available evidence to determine if a present obligation exists at the balance sheet date.
- If a present obligation is more likely than not, a provision is recognized (if criteria are met).
- If no present obligation is likely, a contingent liability is disclosed unless the outflow of resources is remote.

**Past Event**
- A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.
- Provisions are not recognized for future operating costs, only for existing liabilities at the balance sheet date.
- Obligations from past events, independent of future actions, are recognized as provisions.
- A non-obligating event may become one later due to legal changes, requiring rectification of past damage.

### Contingent Assets

- Contingent assets arise from unexpected events that may lead to economic benefits.
- They are not recognized to avoid recording unrealized income.
- They are not disclosed in financial statements but may be mentioned in reports if an inflow is probable.
- If an inflow becomes virtually certain, the asset and related income are recognized.

**Table- Provisions and contingent liabilities**

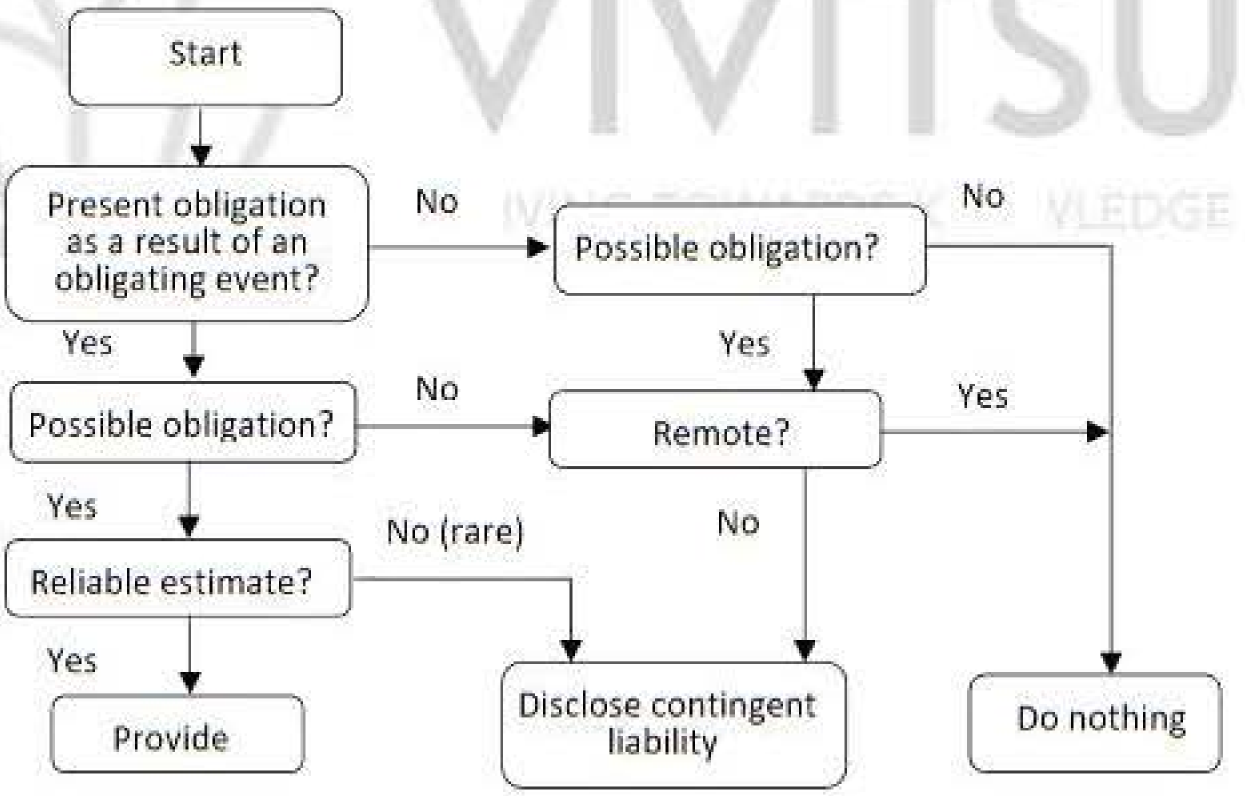
Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of:

- a present obligation the one whose existence at the balance sheet date is considered probable; or
- a possible obligation the existence of which at the balance sheet date is considered not probable.

| | | |
|---|---|---|
| – There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation. | – There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources. | – There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote. |
| – A provision is recognised. Disclosures are required for the provision. | – No provision is recognised. Disclosures are required for the contingent liability. | – No provision is recognised. No disclosure is required. |

### Future Events

- Provisions are recognized only for obligations from past events, independent of future actions.
- Future events affecting settlement amounts are considered if supported by objective evidence.
- Possible new legislation is factored in when its enactment is virtually certain.




### Disclosure

**For each class of provision, an enterprise should disclose:**

- Carrying amount at the beginning and end of the period;
- Unused amounts reversed during the period.
- Additional provisions made in the period, Including increases to existing provisions;
- Amounts used (i.e. incurred and charged against the provision) during the period; and

**Question & Answers**

#### Question 1

**Explain whether provision is required in the following situations in line with AS 29:**

**(i) There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation;**

**(ii) There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**

**(iii) There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.** ***(RTP May 21)***

**Answer 1**

**(i)** There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation – Provision is recognized. Disclosures are required for the provision.

**(ii)** There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources – No provision is recognised. Disclosures are required for the contingent liability.

(iii) There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote – No provision is recognised. No disclosure is required.

## Question 2

**An airline is required by law to overhaul its aircraft once in every five years. The pacific Airlines which operate aircrafts does not provide any provision as required by law in its final accounts. You are required to comment on the validity of the treatment done by the company in line with the provisions of AS 29.** ***(MTP 5 Marks- Oct'19, Aug'18, Nov'21 & April '23)***

**Answer 2**

A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is recognized as per AS 29. The cost of overhauling aircraft is not recognized as a provision because it is a future obligation and the incurring of the expenditure depends on the company's decision to continue operating the aircrafts. Even a legal requirement to overhaul does not require the company to make a provision for the cost of overhaul because there is no present obligation to overhaul the aircrafts. Further, the enterprise can avoid the future expenditure by its future action, for example by selling the aircraft. However, an obligation might arise to pay fines or penalties under the legislation after completion of five years. Assessment of probability of incurring fines and penalties depends upon the provisions of the legislation and the stringency of the enforcement regime. A provision should be recognized for the best estimate of any fines and penalties if airline continues to operate aircrafts for more than five years.

## Question 3

**XYZ Ltd. has not made provision for warrantee in respect of certain goods due to the fact that the company can claim the warranty cost from the original supplier. Hence the accountant of the company says that the company is not having any liability for warrantees on a particular date as the amount gets reimbursed. You are required to comment on the accounting treatment done by the XYZ Ltd. in line with the provisions of AS 29.** ***(MTP 5 Marks Mar'22 & Sep '22, RTP Nov'19, RTP May 21, May 18) (MTP 4 Marks Apr'24, MTP 6 Marks Dec'24)***

**Answer 3**

As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision. It is apparent from the Question that the company had not made provision for warranty in respect of certain goods considering that the company can claim the warranty cost from the original supplier. However, the provision for warranty should have been made as per AS 29 and the amount claimable as reimbursement should be treated as a separate asset in the financial statements of the company rather than omitting the disclosure of such liability. Accordingly, it is viewed that the accounting treatment adopted by the company with respect to warranty is not correct.

## Question 4

**A company incorporated under Section 8 of the Companies Act, 2013, have main objective to promote the trade by organizing trade fairs / exhibitions. When company was organizing the trade fair and exhibitions it decided to charge 5% contingency charges for the participants/outside agencies on the**

**income received from them by the company, while in the case of fairs organized by outside agencies, 5% contingency charges are levied separately in the invoice, the contingency charges in respect of fairs organized by the company itself are inbuilt in the space rent charged from the participants. Both are credited to Income and Expenditure Account of the company.**

**The intention of levying these charges is to meet any unforeseen liability, which may arise in future. The instances of such unforeseen liabilities could be on account of injury/loss of life to visitors/ exhibitors,**

**etc., due to fire, terrorist attack, stampede, natural calamities and other public and third party liability. The chances of occurrence of these events are high because of large crowds visiting the fair. The decision to levy 5% contingency charges was based on assessment only as actual liability on this account cannot be estimated.**

**The following accounting treatment and disclosure was made by the company in its financial statements:**

1. **5% contingency charges are treated as income and matching provision for the same is also being made in accounts.**
2. **A suitable disclosure to this effect is also made in the notes forming part of accounts.**

**Required:**

**(i) Whether creation of provision for contingencies under the facts and circumstances of the case is in conformity with AS 29.**

**(ii) If the answer of (I) is "No" then what should be the treatment of the provision which is already created in the balance sheet. (RTP Sep'24)**

**Answer 4**

(i) Para 14 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets" states that a provision should be recognized when (a) An enterprise has a present obligation as a result of a past event and (b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and (c) A reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognized.

From the above, it is clear that in the contingencies considered by the company, neither a present obligation exists as a result of past event, nor a reliable estimate can be made of the amount of the obligation. Accordingly, a provision cannot be recognized for such contingencies under the facts and circumstances of the case.

(ii) "Provision" is the amount retained by the way of providing for any known liability. Since the contingencies stipulated by the company are not known at the balance sheet date, the provision in this regard cannot be created. Therefore, the provision so created by the company shall be treated as a 'Reserve'.

## Question 5

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

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

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

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

**Kindly give your Answer for each of above with proper reasoning according to the relevant Accounting Standard. Also state the principles for recognition of provision, as per AS 29. *(RTP May'22)***

**Answer 5**

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

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

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

(iii) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised."

**Accounting treatment under the given scenarios:**

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

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

(iii) The obligating event is the sale of health care equipment with a warranty, which gives rise to a legal obligation. Here, an outflow of resources embodying economic benefits in settlement is probable for the warranties as a whole. Hence, a provision is recognized for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period as follows: Probability of warranty cases for the entity where repair/replacement may be required as per past experience
= 1% of Rs. 5,00,00,000 = Rs. 5,00,000
Estimated cost of repair / replacement = Rs. 5,00,000 x 10% = Rs. 50,000.

## Question 6

**Chaos Limited is in the process of finalizing its accounts for the year ended 31st March, 2022. It seeks your advice in the following cases:**

**(i) Chaos Limited entered into an agreement to supply 1 lac face masks to D Limited by 30th April, 2022 failing which it will have to pay a penalty of ` 10 per item not supplied. On 31st March, 2022 Chaos Limited assessed that it could only supply 50,000 face masks to D Limited by 30th April, 2022.**

**(ii) Chaos Limited has filed a court case in 2014-2015 against its competitors. It is evident to its lawyers that Chaos Limited may lose the case and would have to pay ` 3,00,000 being the cost of litigation. No entries/provisions have been made in the books.**

**(iii) A new regulation has been passed in 2021-22 by the healthcare ministry to upgrade facilities. Deadline set by the government is 31.03.2023. The company estimates an expenditure of ` 10,00,000 for the said upgrade.**

**Kindly give your answer for each of above with proper reasoning according to the relevant Accounting Standard. Also state the principles for recognition of provision, as per AS 29. *(RTP Nov'22)***

**Answer 6**

Principles for recognition of provisions:

As per AS 29, "a provision shall be recognised when:

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

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

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised."

**Accounting treatment under the given scenarios:**

(i) In this case, there is no present obligation arising out of a past event as the goods are scheduled for delivery on 30th April, 2022 and there is no delay as at 31st March, 2022. Hence, there is no present obligation to pay the penalty in the current year. Therefore, no provision can be recognized in the instant case.

(ii) On 31st March, 2022, since it is evident to the lawyer that Chaos Limited may lose the case and also a reliable estimate of the outflow can be made as ` 3,00,000, there is a present obligation. Hence, provision should be recognised for ` 3,00,000 for the amount which may be required to settle the obligation.

(iii) Under new regulation, an entity is required to upgrade its facilities by 31st March, 2023. However, on 31st March, 2022, i.e. at the end of the reporting period, there is no obligation because there is no obligating event either for the costs of upgrading the facilities or for fines under the regulations. Hence, no provision should be recognised on 31st March, 2022 for upgrading the facilities by 31st March, 2023.

## Question 7

**(a) A company, incorporated as NPO under the Companies Act, is having main objective to promote the trade by organizing trade fairs / exhibitions. While organizing the trade fair and exhibitions, it decided to charge 5% contingency charges for the participants/outside agencies on the income received from them by the company, while in the case of fairs organized by outside agencies, 5% contingency charges are levied separately in the invoice, the contingency charges in respect of fairs organized by the company itself are inbuilt in the space rent charged from the participants. Both are credited to Income and Expenditure Account of the company.**

**The intention of levying these charges is to meet any unforeseen liability, which may arise in future. The instances of such unforeseen liabilities could be on account of injury/loss of life to visitors/ exhibitors, etc., due to fire, terrorist attack, stampede, natural calamities and other public and third party liability. The chances of occurrence of these events are high because of large crowds visiting the fair. The decision to levy 5% contingency charges was based on assessment only as actual liability on this account cannot be estimated.**

**The accounting treatment and disclosure was made by the company in its financial statements as: (i) 5% contingency charges are treated as income and matching provision for the same is also being made in accounts and (ii) suitable disclosure to this effect is also made in the notes forming part of accounts. You are required to comment whether creation of provision for contingencies considering the facts and circumstances of the case is required in line with AS 29.**

**(b) An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. On 31st March 2021, it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary considering the circumstances in line with provisions of AS 29? *(RTP Nov '21, SM)***



**Answer 7**

**(a)** As per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", a provision should be recognized when (a) An enterprise has a present obligation as a result of a past event and (b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and (c) A reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognized.

From the above, it is clear that for the contingencies considered by the company, neither a present obligation exists because of past event, nor a reliable estimate can be made of the amount of the obligation. Accordingly, a provision cannot be recognized for such contingencies under the facts and circumstances of the case.

**(b)** As per AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a past event will lead to present obligation when the enterprise has no realistic alternative to settle the obligation created by the past event. However, when environmental damage is caused there may be no obligation to remedy the consequences. The causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted. In the given case it is virtually certain that law will be enacted requiring clean-up of a land already contaminated. Therefore, an oil company has to provide for such clean-up cost in the year in which the law is virtually certain to be enacted.

## Question 8

**Alloy Fabrication Limited is engaged in manufacturing of iron and steel rods. The company is in the process of finalization of the accounts for the year ended 31 st March,2022 and needs your advice on the following issues in line with the provisions of AS-29:**

I. **On 1stApril,2019, the company installed a huge furnace in their plant. The furnace has a lining that needs to be replaced every five years for technical reasons. At the Balance Sheet date 31st March,2022, the company does not provide any provision for replacement of lining of the furnace.**

II. **A case has been filed against the company in the consumer court and a notice for levy of a penalty of ₹ 50 Lakhs has been received. The company has appointed a lawyer to defend the case for a fee of ₹ 5 Lakhs. 60% of the fees have been paid in advance and rest 40% will be paid after finalization of the case.**

There are 70% chances that the penalty may not be levied. *(PYP 5 Marks May'22)*

**Answer 8**

I. A provision should be recognized only when an enterprise has a present obligation arising from a past event or obligation. In the given case, there is no present obligation but a future one, therefore no provision is **recognized** as per AS 29. The cost of replacement of lining of furnace is not recognized as a provision because it is a future obligation. Even a legal requirement does not require the company to make a provision for the cost of replacement because there is no present obligation. Even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

II. As per AS 29, an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. Liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

In the given case, there are 70% chances that the penalty may not be levied. Accordingly, Alloy Fabrication Ltd. should not make the provision for penalty. The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote. However, a provision should be made for remaining 40% fees of the lawyer amounting₹ 2,00,000 in the financial statements of financial year 2021-2022.

**EXAM INSIGHTS:** Few examinees could not give the correct advice on the issues given in the question for finalization of accounts in line with "AS 29 Provisions, Contingent Assets and Contingent Liabilities".

## Question 9

**(i) XYZ Ltd. is in a dispute with a competitor company. The dispute is regarding alleged infringement of Copyrights. The competitor has filed a suit in the court of law seeking damages of Rs. 200 lacs.**
**The Directors are of the view that the claim can be successfully resisted by the Company.**
**How would the matter be dealt in the annual accounts of the Company in the light of AS 29? Explain in brief giving reasons for your answer.**

**(ii) What is meant by "Restructuring Provision" as per AS 29? What costs are excluded while computing such provision as per the standard? *(MTP 5 Marks April 21, April 22)***

**Answer 9**

**(i)** As per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets', a provision should be recognized when

- an enterprise has a present obligation as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognized.

In the given situation, since, the directors of the company are of the opinion that the claim can be successfully resisted by the company, therefore there will be no outflow of the resources. Hence, no provision is required. The company will disclose the same as contingent liability by way of the following note:

"Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed copyrights and is seeking damages of Rs. 200 lakhs. However, the directors are of the opinion that the claim can be successfully resisted by the company."

**(ii)** As per AS 29, a restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both: (a) necessarily entailed by the restructuring; and (b) Not associated with the ongoing activities of the enterprise. A restructuring provision does not include such costs as: (a) Retraining or relocating continuing staff; (b) Marketing; or (c) Investment in new systems and distribution networks.

## Question 10

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

**(i) The company operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Eighty five percent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and fifteen percent arise through the extraction of oil. At the balance sheet date, rig has been constructed but no oil has been extracted.** ***(MTP 5 Marks March 21, RTP May'20, PYP 2.5 Marks Nov'20, SM, RTP Nov '23, MTP 5 Marks Sep '23)***

**(ii) The Government introduces a number of changes to the taxation laws. As a result of these changes, the company will need to train a large proportion of its accounting and legal workforce in order to ensure continued compliances with tax law regulations. At the balance sheet date, no retraining of staff has taken place.** ***(RTP Nov '23)(MTP 5 Marks Sep '23)***

**Answer 10**

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

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

(ii) As per AS 29, a provision for restructuring costs is recognized only when the recognition criteria for provisions are met. A restructuring provision does not include costs as of retraining or relocating continuing staff.

The expenditures of training the staff related to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognized on the same basis as if they arose independently of a restructuring. At the balance sheet date, no such expenditure has been incurred hence no provision is required.

## Question 11

**During the year, Wivitzu Ltd. delivered manufactured products to customer K. The products were faulty and on 1st October, 2023 customer K commenced legal action against the Company claiming damages in respect of losses due to the supply of faulty product. Upon investigating the matter, Wivitzu Ltd. discovered that the products were faulty due to defective raw material procured from supplier F. Therefore, on 1st December, 2023, the Company commenced legal action against F claiming damages in respect of the supply of defective raw materials.**

**Wivitzu Ltd. has estimated that it's probability of success of both legal actions, the action of K against Wivitzu Ltd. and action of Wivitzu Ltd. against F, is very high.**

**On 1st October, 2023, Wivitzu Ltd. has estimated that the damages it would have to pay K would be ₹ 5 crore. This estimate was revised to ₹ 5.2 crore as on 31st March, 2024 and ₹ 5.25 crore as at 15th May, 2024. This case was eventually settled on 1st June, 2022, when the Company paid damages of ₹ 5.3 crore to K.**

**On 1st December, 2023, Wivitzu Ltd. had estimated that it would receive damages of ₹ 3.5 crore from F. This estimate was revised to ₹ 3.6 crore as at 31st March, 2024 and ₹ 3.7 crore as on 15th May, 2024. This case was eventually settled on 1st June, 2022 when F paid ₹ 3.75 crore to Wivitzu Ltd. Wivitzu Ltd. had, in its financial statements for the year ended 31st March, 2024, provided ₹ 3.6 crore as the financial statements were approved by the Board of Directors on 26th April, 2024.**

**(i) Whether the Company is required to make provision for the claim from customer K as per applicable AS? If yes, please give the rationale for the same.**

**(ii) If the answer to (a) above is yes, what is the entry to be passed in the books of account as on 31st March, 2024?**

**(iii) What will the accounting treatment of the action of Wivitzu Ltd. against supplier F as per applicable AS? *(RTP Jan'25)***

**Answer 11**

(i) Yes, Wivitzu Ltd. is required to make provision for the claim from customer K as per AS 29 since the claim is a present obligation as a result of delivery of faulty goods manufactured. Also, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations. Further, a reliable estimate of ₹ 5.2 crore can be made of the amount of the obligation while preparing the financial statements as on 31st March, 2024.

(ii) Statement of Profit and Loss A/c Dr. ₹ 5.2 crore
To Current Liability A/c ₹ 5.2 crore

(iii) As per para 30 of AS 29, Wivitzu Ltd. shall not recognise a contingent asset. Here the probability of success of legal action is very high but there is no concrete evidence which makes the inflow virtually certain. Hence, it will be considered as contingent asset only and shall not be recognized.

## Question 12

**Saharsh Ltd. is engaged in manufacturing of electric home appliances. The company is in the process of finalizing its accounts for the year ended 31.3.2022 and needs your expert advice on the following issues in line with the provisions of AS 29:**

**(i) A case has been filed against the company in the consumer court and a notice for levy of a penalty of Rs. 20 lakhs has been received. The company has appointed a lawyer to defend the case for a fee of Rs. 2 lakhs. 50% of the fees has been paid and balance 50% will be paid after finalization of the case. There are 75% chances that the penalty may not be levied.**

**(ii) The company had committed to supply a consignment worth Rs. 1 crore to one of its dealers by the year-end. As per the contract, if delivery is not made on time, a compensation of 15% is to be paid on the value of delayed/lost consignment. While the consignment was in transit, one of the trucks carrying goods worth Rs. 30 lakhs met with an accident. It was however covered by Insurance. According to the surveyor's report, the policy amount is collectable, subject to 10% deduction. Before closing the books of accounts, the company has received the information that the policy amount has been processed and the dealer has also claimed the compensation for the consignment of goods worth Rs. 30 lakhs which was in transit. *(MTP 5 Marks Oct '21, March '23 & Oct '23)***

**Answer 12**

**(i)** As per AS 29, an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not. Liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. In the given case, there are 75% chances that the penalty may not be levied. Accordingly, Saharsh Ltd. should not make the provision for penalty. However, a provision should be made for remaining 50% fees of the lawyer in the financial statements of financial year 2021-2022.

| | | |
|---|---|---|
| **(ii)** | Loss due to accident | Rs. 30,00,000 |
| | Insurance claim receivable by company = Rs. 30,00,000 x 90% | Rs. 27,00,000 |
| | Loss to be recognised in the books for 2021-2022 | Rs. 3,00,000 |
| | Insurance claim receivable to be recorded in the books | Rs. 27,00,000 |

Compensation claim by dealer against company to be provided for in the books
= Rs. 30,00,000 x 15% = Rs. 4,50,000

## Question 13

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

| Particulars | Probability | Loss (₹) |
|---|---|---|
| In respect of five cases | 100% | - |
| (Win) Next ten cases (Win) | 50% | - |

| | | |
|---|---|---|
| Lose (Low damages) | 40% | 12,00,000 |
| Lose (High damages) | 10% | 20,00,000 |
| Remaining five cases | 50% | - |
| Win Lose (Low damages) | 30% | 10,00,000 |
| Lose (High damages) | 20% | 21,00,000 |

**Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof as per AS - 29.** ***(PYP 5 Marks Nov 22)***

**Answer 13**

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

(i) There is a present obligation arising out of past events but not recognized as provision.

(ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(iii) The possibility of an outflow of resources embodying economic benefits is not remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

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

Expected loss in next ten cases = 40% of ₹ 12,00,000 + 10% of ₹ 20,00,000
= ₹ 4,80,000 + ₹ 2,00,000
= 6,80,000

Expected loss in remaining five cases = 30% of ₹ 10,00,000 + 20% of ₹ 21,00,000
= ₹ 3,00,000 + ₹ 4,20,000
= ₹ 7,20,000

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

**EXAM INSIGHTS** : Most of the examinees failed to compute the amount of contingent loss and the accounting treatment in line with AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

## Question 14

**A Company dealing in software provides after sales warranty for 2 years to its customer. Based on past experience, the company has been following policy for making provision for warranties on the invoice amount, on the remaining balance warranty period:**

**Less than 1 year: 3% provision**

**More than 1 year: 4% provision**

**The company has raised invoices as under:**

| Invoice Date | Amount (₹) |
|---|---|
| 19th January, 2019 | 1,20,000 |
| 29th January, 2020 | 75,000 |
| 15th October, 2020 | 2,70,000 |

**You are required to calculate the provision to be made for warranty under Accounting Standard 29 as at 31st March, 2020 and 31st March, 2021. Also compute the amount to be debited to Profit and Loss Account for the year ended 31st March, 2021.*(MTP 5 Marks Oct'22, PYP 5 Marks Nov '19, RTP May '23) (Same concept different figures New SM, MTP 4 Marks Nov'24)***

**Answer 14**

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

As at 31st March, 2020 = ₹ 1,20,000 x .03 + ₹ 75,000 x .04

= ₹ 3,600 + ₹ 3,000 = ₹ 6,600

As at 31st March, 2021 = ₹ 75,000 x .03 + ₹ 2,70,000 x .04

= ₹ 2,250 + ₹ 10,800 = ₹ 13,050

**Amount debited to Profit and Loss Account for year ended 31st March, 2021**

| | ₹ |
|---|---|
| Balance of provision required as on 31.03.2021 | 13,050 |
| Less: Opening Balance as on 1.4.2020 | (6,600) |
| Amount debited to profit and loss account | 6,450 |

Note: No provision will be made on 31st March, 2021 in respect of sales amounting ₹ 1,20,000 made on 19th January, 2019 as the warranty period of 2 years has already expired.

## Question 15

LDR

**A Limited sells goods with unlimited right of return to its customers. The following pattern has been observed in the Return of Sales:**

| Time frame of Return from date of purchase | % of Cumulative Sales |
|---|---|
| Between 0-1 month | 6% |
| Between 1-2 months | 7% |
| Between 2-3 months | 8% |

**The Company has made Sales of ₹ 36 Lakhs in the month of January, ₹ 48 Lakhs in the month of February and of ₹ 60 Lakhs in the month of March. The Total Sales for the Financial Year have been ₹ 400 Lakhs and the Cost of Sales was ₹ 320 Lakhs. You are required to determine the amount of Provision to be made and Revenue to be recognized as on 31st March.** ***(PYP 5 Marks, July 21, MTP Sep'23)***

**Answer 15**

Amount of provision

The goods are sold with a right to return. The existence of such right gives rise to a present obligation on the company as per AS 29, 'Provisions, Contingent Liabilities and Contingent Assets'. According to the standard, a provision should be created on the Balance sheet date, for sales returns after the Balance Sheet date, at the best estimate of the loss expected, along with any estimated incremental cost that would be necessary to resell the goods expected to be returned.

| Sales during | Sales value (₹ in lacs) | Sales value (cumulative) ₹ (in lacs) | Likely returns (%) | Likely returns ₹ (in lacs) | Provision @ 20% (₹ in lacs) (Refer W.N.) |
|---|---|---|---|---|---|
| March | 60 | 60 | 6% | 3.60 | 0.720 |
| February | 48 | 108 | 7% | 7.56 | 1.512 |
| January | 36 | 144 | 8% | 11.52 | 2.304 |
| Total | | | | 22.68 | 4.536 |

**Revenue to be recognized**

Revenue in respect of sale of goods is recognized fully at the time of sale itself assumed that the company has complied with the conditions stated in AS 9 relating to recognition of revenue in the case of sale of goods. As per AS 9, in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

(i) Seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods. AS 9 also provides that in case of retail sales offering a guarantee of 'money back, if not completely satisfied, it may be appropriate to recognize the sale but to make a suitable provision for returns based on previous experiences.

Therefore, sale of ₹ 36 lakhs, ₹ 48 lakhs and ₹ 60 lakhs made in the months of January, February and March will be recognized at full value. Thus, total revenue to be recognized for RS. 400 lacs for the year.

**Working Note:**

**Calculation of Profit % on sales**

| | (₹ in lacs) |
|---|---|
| Sales for the year | 400 |
| Less: Cost of sales | (320) |
| Profit | 80 |
| Profit mark up on sales (80/400) x 100 = 20% | |

**EXAM INSIGHTS:** Some of the examinees did not determine the amount of provision to be made and revenue to be recognized correctly as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

## Multiple Choice Questions (MCQs)

1. **Which of the following best describes a provision? *(SM)***
   (a) A provision is a liability of uncertain timing or amount.
   (b) A provision is a possible obligation of uncertain timing.
   (c) A provision is a credit balance set up to offset a contingent asset so thatthe effect on the statement of financial position is nil.
   (d) A provision is a possible obligation of uncertain amount.

**Ans:(a)**

2. **X Co is a business that sells second hand cars. If a car develops a fault within 30 days of the sale, X Co will repair it free of charge. At 1 st March 20X1, X Co had made a provision for repairs of ₹ 25,000. At 31st March 20X1, X Co calculated that the provision should be ₹ 20,000. What entry should be made for the provision in X Co's income statement for the month 31st March 20X1? *(SM)***
   (a) A charge of ₹ 5,000
   (b) A credit of ₹ 5,000
   (c) A charge of ₹ 20,000
   (d) A credit of ₹ 25,000

**Ans:(b)**

3. **Which of the following item does the statement below describe? "A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control" *(SM)***
   (a) A provision
   (b) A current liability
   (c) A contingent liability
   (d) Deferred tax liability

**Ans:(c)**

4. **Z Ltd has commenced a legal action against Y Ltd claiming substantial damages for supply of a faulty product. The lawyers of Y Ltd have advised that the company is likely to lose the case, although the chances of paying the claim is not remote. The estimated potential liability estimated by the lawyers are:**
   **Legal cost (to be incurred irrespective of the outcome of the case) ₹ 50,000 Settlement if the claim is required to be paid ₹ 5,00,000**
   **What is the appropriate accounting treatment in the books of Z Ltd.? *(SM)***
   (a) Create a Provision of ₹ 5,50,000
   (b) Make a Disclosure of a contingent liability of ₹ 5,50,000
   (c) Create a Provision of ₹ 50,000 and make a disclosure of contingentliability of ₹ 5,00,000
   (d) Create a Provision of ₹ 5,00,000

**Ans:(c)**

# CHAPTER 7.1: AS 4 CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

| CONCEPTS OF THIS CHAPTER | | LDR Questions |
|---|---|---|
| • Contingencies<br>• Contingent Gains<br>• Contingent Losses | • Events After Balance Sheet Date:<br>• Adjusting Events<br>• Non-adjusting Events | Q 10 |

## QUICK REVIEW OF IMPORTANT CONCEPTS

**AS 4 deals with**

- Events occurring after the balance sheet date
- Contingencies* Excluding
  - Liabilities of life assurance and general insurance enterprises arising from policies issued;
  - Obligations under retirement benefit plans
  - Commitments arising from long-term lease contracts

**Contingency Condition/Situation Ultimate outcome**

Ultimate outcome is only recognized on the occurrence, or non occurrence, of one or more uncertain future events

| | | |
|---|---|---|
| **Gain** | Not recognised in the financial statements | |
| **Loss** | **Charge in the statement of profit and loss** | • It is probable that future events will confirm that, after considering related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date;<br>• Reasonable estimate of the amount of the resulting loss can be made. |
| | | • Disclosed in the financial statements. If either of the conditions (a) and (b) is not met, unless the possibility of a loss is remote. |

| | | |
|---|---|---|
| **Events occurring after the reporting period** | Adjusting events | • Those which provide further evidence of conditions that existed at the balance sheet date<br>• Adjust the amounts recognised in the financial statements to reflect it |
| | Non-adjusting events | • Those which are indicative of conditions that arose after the balance sheet date. |
| | | • Do not adjust the amounts recognised in the financial statements to reflect it<br>If non-adjusting events after the reporting period are material, then **disclose**<br>• the nature of the event; and<br>• an estimate of its financial effect, or a statement that such an estimate cannot be made. |

**Dividend**

- A dividend declared after the reporting period but before the approval of the financial statements should not be recognized as a liability at the end of the reporting period.
- It should be disclosed in the notes to the financial statements.
- No obligation exists at the end of the reporting period for the declared dividend.

## Question & Answers

Question 1

**Explain accounting treatment of Contingent Gains as per AS 4 "Contingencies and Events occurring after the Balance Sheet Date". *(RTP Nov'22)***

**Answer 1**

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate

Question 2

**A case is going on between ABC Ltd. and Tax department on claiming the exemption for certain items, for the year 2019-2020. The court has issued the order on 15th April and rejected the claim of the company. Accordingly, company is liable to pay the additional tax. The financial statements were approved on 31st May, 2020. Shall company account for such tax in the year 2019-2020 or shall it account for in the year 2020-2021? *(RTP May'21)***

**Answer 2**

To decide whether, the event is adjusting or not adjusting two conditions need to be satisfied,

(a) There has to be evidence

(b) The event must have been related to period ending on reporting date.

Here both the conditions are satisfied. Court order is a conclusive evidence which has been received before approval of the financial statements since the liability is related to earlier year. The event will be considered as an adjusting event and accordingly the amount will be adjusted in accounts of 2019-2020.

Question 3

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

i. **A suit against the Company's Advertisement was filed by a party on 5th April, 2023, claiming damages of ₹ 5 lakhs.**

ii. **Company sends a proposal to sell an immovable property for ₹ 45 lakhs in March 2023. The book value of the property is ₹ 30 lakhs as on year end date. However, the Deed was registered on 15th April, 2023.**

**Keeping in view the provisions of AS-4, you are required to state with reasons whether the above events are to be treated as Contingencies, Adjusting Events or Non-Adjusting Events occurring after Balance Sheet date. *(RTP May'24)***

**Answer 3**

Accordingly, the treatment as per AS - 4 "Events occurring after the balance sheet date" is:

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

(ii) In this case, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2023. There was just a proposal before 31st March, 2023 and hence sale cannot be shown in the financial statements for the year ended 31st March, 2023.

Sale of immovable property is an event occurring after the balance sheet date is a non-adjusting event.

Question 4

**An earthquake destroyed a major warehouse of PQR Ltd. On 30.4.2021. The accounting year of the company ended on 31.3.2021. The accounts were approved on 30.6.2021. The loss from earthquake is estimated at Rs. 25 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and**

**how the fact of loss is to be disclosed by the company.**
***(MTP 5 Marks Nov'21 & Apr'23, RTP Nov'19, Old & New SM)***

**Answer 4**

AS 4 "Contingencies and Events Occurring after the Balance Sheet Date", states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.2021. Therefore, loss occurred due to earthquake is not to be recognized in the financial year 2020-2021.

However, according the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the Question, the earthquake has caused major destruction; therefore, fundamental accounting assumption of going concern is called upon.

Hence, the fact of earthquake together with an estimated loss of Rs. 25 lakhs should be disclosed in the Report of the Directors for the financial year 2020-2021.

## Question 5

**As per the provision of AS 4, you are required to state with reason whether the following transactions are adjusting event or non-adjusting event for the year ended 31.03.2021 in the books of NEW Ltd. (accounts of the company were approved by board of directors on 10.07.2021):**

1. **Equity Dividend for the year 2020-21 was declared at the rate of 7% on 15.05.2021.**
2. **On 05.03.2021, ₹ 53,000 cash was collected from a customer but not deposited by the cashier. This fraud was detected on 22.06.2021.**
3. **One building got damaged due to occurrence of fire on 23.05.221. Loss was estimated to be ₹ 81,00,000.** ***(PYP 5 Marks Dec'21)***

**Answer 5**

(i) If dividends are declared after the balance sheet date but before the financial statements are approved, the dividends are not recognized as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes. Thus, no liability for dividends needs to be recognized in financial statements for financial year ended 31 st March, 2021 and declaration of dividend is non-adjusting event.

(ii) As per AS 4 'Contingencies and Events occurring after the Balance Sheet Date' an event occurring after the balance sheet date may require adjustment to the reported values of assets, liabilities, expenses or incomes if such events relate to conditions existing at the balance sheet date. In the given case, fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognize the loss. Thus loss amounting ₹ 53,000 should be adjusted in the accounts of the company for the year ended 31st March, 2021 as it is adjusting event.

(iii) AS 4 states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The damage of one building due to fire did not exist on the balance sheet date i.e. 31.3.2021. Therefore, loss occurred due to fire is not to be recognized in the financial year 2020-2021 as it is non-adjusting event.

However, according to the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the fire has caused major destruction; therefore, fundamental accounting assumption of going concern would have to be evaluated. Considering that the going concern assumption is still valid, the fact of fire together with an estimated loss of ₹ 81 lakhs should be disclosed in the report of the approving authority for financial year 2020 -21 to enable users of financial statements to make proper evaluations and decisions.

> **EXAM INSIGHTS:** Majority of the examinees were not able to give the correct bifurcation of events into Adjusting or Non-adjusting events in accordance with AS 4 "Contingencies and Events occurring after balance sheet date".

## Question 6

**The financial statements of Wiwisu Ltd. for the year 2023-24 approved by the Board of Directors on 15th July, 2024. The following information was provided:**

**(i) A suit against the company's advertisement was filed by a party on 20th April, 2024, claiming damages of ₹ 25 lakhs.**

**(ii) The terms and conditions for acquisition of business of another company have been decided by March, 2024. But the financial resources were arranged in April, 2024 and amount invested was ₹ 50 lakhs.**

**(iii) Theft of cash of ₹ 5 lakhs by the cashier on 31st March, 2024 but was detected on 16th July, 2024.**

**(iv) Company sent a proposal to sell an immovable property for ₹ 40 lakhs in March, 2024. The book value of the property was ₹ 30 lakhs on 31st March, 2024. However, the deed was registered on 15th April, 2024.**

**(v) A, major fire has damaged the assets in a factory on 5th April, 2024. However, the assets are fully insured.**

**With reference to AS-4 "Contingencies and events occurring after the balance sheet date", state whether the above mentioned events will be treated as contingencies, adjusting events or non-adjusting events occurring after the balance sheet date.** ***(MTP 7 Marks July'24)***

**Answer 6**

(i) Suit filed against the company is a contingent liability but it was not existing as on balance sheet date as the suit was filed on 20th April after the balance Sheet date. As per AS 4, 'Contingencies' used in the Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur. Hence, it will have no effect on financial statements and will be a non-adjusting event.

(ii) In the given case, terms and conditions for acquisition of business were finalised and carried out before the closure of the books of accounts but transaction for payment of financial resources was effected in April, 2024. This is clearly an event occuring after the balance sheet date. Hence, necessary adjustment to assets and liabilities for acquisition of business is necessary in the financial statements for the year ended 31st March 2024.

(iii) Only those significant events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustment to assets and liabilities existing on the balance sheet date or may require disclosure. In the given case, theft of cash was detected on 16th July, 2024 after approval of financial statements by the Board of Directors, hence no treatment is required.

(iv) Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. In the given case, sale of immovable property was under proposal stage (negotiations also not started) on the balance sheet date. Therefore, no adjustment to assets for sale of immovable property is required in the financial statements for the year ended 31st March, 2024.

(v) The condition of fire occurrence was not existing on the balance sheet date. Only the disclosure regarding event of fire and loss being completely insured may be given in the report of approving authority.

## Question 7

**The financial statements of Alpha Ltd. for the year 2019-2020 were approved by the Board of Directors on 15th July, 2020. The following information was provided:**

**(i) A suit against the company's advertisement was filed by a party on 20th April, 2020 claiming damages of Rs. 25 lakhs.**

**(ii) The terms and conditions for acquisition of business of another company had been decided by March, 2020. But the financial resources were arranged in April, 2020 and amount invested was Rs. 50 lakhs.**

**(iii) Theft of cash of Rs. 5 lakhs by the cashier on 31st March, 2020, was detected on 16th July, 2020.**

**(iv) The company started a negotiation with a party to sell an immovable property for Rs. 40 lakhs in March, 2020. The book value of the property is Rs. 30 lakh on 31st March, 2020. However, the deed was registered on 15th April, 2020.**

**(v) A major fire had damaged the assets in a factory on 5th April, 2020. However, the assets were fully insured. With reference to AS 4, state whether the above-mentioned events will be treated as contingencies, adjusting events or non-adjusting events occurring after the balance sheet date.**

*(MTP 5 Marks Oct'20, May'20, Mar'22, Old & New SM, RTP May'20, May'18, PYP 5 Marks Jul'21, PYP 5 Marks May'19, RTP May'22)*

**Answer 7**

(i) **Non-adjusting event:** Suit filed against the company is a contingent liability but it was not existing as on date of balance sheet date as the suit was filed on 20 th April after the balance sheet date. As per AS 4, 'Contingencies' is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur. Hence, it will have no effect on financial statement and will be a non-adjusting event.

(ii) **Adjusting event**: In the given case, terms and conditions for acquisition of business were finalized before the balance sheet date and carried out before the closure of the books of accounts but transaction for payment of financial resources was effected in April, 2020. Hence, necessary adjustment to assets and liabilities for acquisition of business is necessary in the financial statements for the year ended 31st March 2020.

(iii) **Non-adjusting event:** Only those events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure. In the given case, as the theft of cash was detected on 16th July, 2020 ie after approval of financial statements, no adjustment is required.

(iv) **Non-adjusting event:** Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. In the given case, sale of immovable property was under proposal stage (negotiations only started) on the balance sheet date, and was not finalized. Therefore, adjustment to assets for sale of immovable property is not necessary in the financial statements for the year ended 31st March, 2020. Disclosure may be given in Report of approving Authority.

(v) **Non-adjusting event:** Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The condition of fire occurrence was not existing on the balance sheet date. Only the disclosure regarding fire and loss, being completely insured may be given in the report of approving authority.

**EXAM INSIGHTS:** July 21 - Majority of the examinees failed to state that the events are to be treated as contingencies, adjusting events or non-adjusting events occurring after balance sheet date with reasons in line with the provisions of AS 4 "Contingencies and Events occurring after the Balance Sheet Date". May 19 - Majority of the examinees were not able to classify the events as 'contingencies', adjusting or non-adjusting event as per the provisions of AS-4 "Contingencies and events occurring after the balance sheet date".

## Question 8

**Tee Ltd. closes its books of accounts every year on 31st March. The financial statements for the year ended 31 March 2020 are to be approved by the approving authority on 30 June 2020. During the first quarter of 2020-2021, the following events / transactions has taken place. The accountant of the company seeks your guidance for the following:**

**(i) Tee Ltd. has an inventory of 50 stitching machines costing at Rs. 5,500 per machine as on 31 March 2020. On 31 March 2020 the company is expecting a heavy decline in the demand in next year. The inventories are valued at cost or net realizable value, whichever is lower. During the month of April 2020, due to fall in demand, the prices have gone down drastically. The company has sold 5 machines during this month at a price of Rs. 4,000 per machine.**

**(ii) A fire has broken out in the company's go down on 15 April 2020. The company has estimated a loss of Rs. 25 lakhs of which 75% is recoverable from the Insurance company.**

**(iii) The company has entered into a sale agreement on 30 March 2020 to sell a property for a consideration of Rs. 7,50,000 which is being carried in the books at Rs. 5,50,000 at the year end. The transfer of risk and reward and sale is complete in the month of May 2020 when conveyance and possession get completed.**

**(iv) The company has received, during the year 2018-2019, a government grant of Rs. 15 lakhs for purchase of a machine. The company has received a notice for refund of the said grant on 15 June, 2020 due to violation of some of the conditions of grant during the year 2019-2020.**

**You are required to state with reasons, how the above transactions will be dealt with in the financial statement**

**for the year ended 31st March 2020.** ***(MTP 5 Marks Oct'21 & Oct'23, RTP May'22)***

**Answer 8**

Events occurring after the balance sheet date are those significant events, both favourable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and by the corresponding approving authority in the case of any other entity. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern is not appropriate.

In the given case, financial statements are approved by the approving authority on 30 June 2020.

On the basis of above principles, following will be the accounting treatment in the financial statements for the year ended at 31 March 2020:

(i) Since on 31 March 2020, Tee Ltd. was expecting a heavy decline in the demand of the stitching machine. Therefore, decline in the value during April, 2020 will be considered as an adjusting event. Hence, Tee Ltd. needs to adjust the amounts recognized in its financial statements w.r.t. net realizable value at the end of the reporting period. Accordingly, inventory should be written down to Rs. 4,000 per machine. Total value of inventory in the books will be 50 machines x Rs. 4,000 = Rs. 2,00,000.

(ii) A fire took place after the balance sheet date i.e. during 2020 -2021 financial year. Hence, corresponding financials of 2019-2020 financial year should not be adjusted for loss occurred due to fire. However, in this circumstance, the going concern assumption will be evaluated. In case the going concern assumption is considered to be appropriate even after the occurrence of fire, no disclosure of the same is required in the financial statements. Otherwise, disclosure be given.

(iii) Since the transfer of risk and reward and sale was complete in the month of May, 2020 when conveyance and possession got complete, no revenue should be recognized with respect to it in the financial statements of 2019-2020. However, a disclosure for the same should be given by the entity.

(iv) Since the notice has been received after 31 March but before 30 June 2020 (approval date), the said grant shall be adjusted in the financial statements for financial year 2019 -2020 because the violation of the conditions took place in the financial year 2019 -2020 and the company must be aware of it.

## Question 9

**For five companies whose financial year ended on 31st March, 2023, the financial statements were approved by their approving authority on 15th June, 2023.**

**During 2023-2024, the following material events took place:**

a. **A Ltd. sold a major property which was included in the balance sheet at ₹ 1,00,000 and for which contracts had been exchanged on 15th March, 2023. The** sale was **completed on 15th May, 2023 at a price of ₹ 2,50,000.**

b. **On 30th April, 2023, a 100% subsidiary of B Ltd. declared a dividend of ₹ 3,00,000 in respect of its own shares for the year ended on 31st March, 2023.**

c. **On 31st May, 2023, the mail order activities of C Ltd. (a retail trading group) were shut down with closure costs amounting to ₹ 2.5 million.**

d. **On 1st July, 2023 the discovery of sand under D Ltd.'s major civil engineering contract site causes the cost of the contract to increase by 25% for .which there would be no corresponding recovery from the customer.**

e. **A fire, on 2nd April, 2023, completely destroyed a manufacturing plant of E Ltd. It was expected that the loss of ₹ 10 million would be fully covered by the insurance company.**

**You are required to state with reasons, how each of the above items numbered (a) to (e) should be dealt with in the financial statement of the various companies for the year ended 31st March, 2023. (RTP Sep'24)** ***(RTP Nov'21, PYP 5 Marks Nov'22)***

**Answer 9**

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

| | | |
|---|---|---|
| (a) | A Ltd. | The sale of property should be treated as an adjusting event since contracts had been exchanged prior to the year-end. The effect of the sale would be reflected in the financial statements ended on 31.3.2023 and the profit on sale of property ₹ 1,50,000 would be treated as an extraordinary item. |

| | | |
|---|---|---|
| (b) | B Ltd. | The declaration of dividend on 30th April, 2023 of ₹ 3,00,000 would be treated as a non-adjusting event in the financial statements of 2022-2023. This is because, the dividend has been declared after the balance sheet date and no conditions existed on the balance sheet date for such declaration of dividend. Further as per AS 9, right to receive dividend is established when it is declared and not before that. |
| (c) | C Ltd. | A closure not anticipated at the year-end would be treated as a non-adjusting event. Memorandum disclosure would be required for closure of mail order activities since non- disclosure would affect user's understanding of the financial statements. |
| (d) | D Ltd. | The event took place after the financial statements were approved by the approving authority and is thus outside the purview of AS 4. However, in view of its significance of the transaction, the directors may consider publishing a separate financial statement/additional statement for the attention of the members in general meeting. |
| (e) | E Ltd. | The event is a non-adjusting event since it occurred after the year-end and does not relate to the conditions existing at the year-end. However, it is necessary to consider the validity of the going concern assumption having regard to the extent of insurance cover. Also, since it is said that the loss would be fully recovered by the insurance company, the fact should be disclosed by way of a note to the financial statements. |

## Question 10

LDR

**State with reasons, how the following events would be dealt with in the financial statements of Hari Ltd. for the year ended 31st March, 2024 (accounts were approved on 25th July, 2024):**

**(1) Negotiations with another company for acquisition of its business was started on 21st January, 2024. Hari Ltd. invested ₹ 40 lakh on 22nd April, 2024.**

**(2) The company made a provision for bad debts @ 4% of its total debtors (as per trend followed from the previous years). In the second week of March 2024, a debtor for ₹ 2,50,000 had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In May, 2024 the debtor became bankrupt.**

**(3) During the year 2023-24, Hari Ltd. was sued by a competitor for ₹ 13 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Hari Ltd. provided for a sum of ₹ 8 lakhs in its financial statements for the year ended 31st March, 2024. On 26th May, 2024, the Court decided in favour of the party alleging infringement of the trademark and ordered Hari Ltd. to pay the aggrieved party a sum of ₹ 12 lakhs.**

**(4) Cashier of Hari Ltd. embezzled cash amounting to ₹ 3,00,000 during March, 2024. However the same comes to the notice of Company management during August, 2024.**

**(5) Cheques dated 31st March, 2024 collected in the month of April, 2024. All cheques are presented to the bank in the month of April, 2024 and are also realized in the same month in the normal course after deposit in the bank. *(MTP 7 Marks Dec'24, MTP 5 Marks Sep'22, Old & New SM)***

**Answer 10**

(i) As per AS 4'Contingencies and Events Occurring After the Balance Sheet Date', disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 40 lakhs in April, 2024 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

(ii) As per AS 4, adjustment 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. A debtor for ₹ 2,50,000 suffered heavy loss due to earthquake in the second week of March, 2024 which was not covered by insurance. This information with its implications was already known to the company. The fact that he became bankrupt in May, 2024 (after the balance sheet date) is only an additional information related to the existing condition on the balance sheet date. Accordingly, full provision for bad debts amounting ₹ 2,50,000 should be made, to cover the loss arising due to the insolvency of a debtor, in the final accounts for the year ended 31st March 2024.

(iii) As per AS 4, 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 Hari Ltd. was sued by a competitor for infringement of a trademark during the year 2023-24 for which the provision was also made by it, the decision of the Court on 26th May, 2024, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Hari 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.

(iv) As the embezzlement of cash comes to the notice of company management only after approval of financial statements by board of directors of the company, then the treatment will be done as per the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" and the same will not be adjusted in the financial statements for the year ended 31st March, 2024. This being an extra-ordinary item should be disclosed in the statement of profit and loss as a part of loss for the year ending March, 2025, in a manner, that its impact on current profit or loss can be perceived.

(v) Collection of cheques after balance sheet date is not an adjusting event even if the cheques bear the date of 31st March. Recognition of cheques in hand is therefore not consistent with requirements of AS 4. Moreover, the collection of cheques after balance sheet date does not represent any material change or commitments affecting financial position of the enterprise and no disclosure of such collections in the Directors' Report is necessary.

## Multiple Choice Questions (MCQs)

**1. Cash amounting to ₹ 4 lakhs, stolen by the cashier in the month of March 20X1, was detected in April, 20X1. The financial statements for the year ended 31st March, 20X1 were approved by the Board of Directors on 15th May, 20X1. As per Accounting Standards, this is________ for the financial statements year ended on 31st March, 20X1. *(SM)***

(a) An Adjusting event.
(b) Non-adjusting event.
(c) Contingency.
(d) Provision

**Ans: (a)**

**2. As per Accounting Standards, events occurring after the balance sheet date are *(SM)***

(a) Only favorable events that occur between the balance sheet date and the date when the financial statements are approved by the Board of directors.
(b) Only unfavorable events that occur between the balance sheet date and the date when the financial statements are approved by the Board of directors.
(c) Those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of directors.
(d) Those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are not approved by the Board of directors.

**Ans: (c)**

**3. AS 4 does not apply to *(SM)***

(a) Obligation under retirement benefit plans.
(b) Commitments arising from long term lease contracts
(c) liabilities of life assurance and general insurance enterprises arising from policies issued
(d) all of the above

**Ans: (d)**

**4. A Ltd. sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31st March, 20X1, the documentation and legal formalities are pending. For the financial year ended 31st March, 20X1 *(SM)***

(a) The company should record the sale.
(b) The company should recognise the profit of ₹ 20 lakhs in its profit and loss account.
(c) Both (a) and (b).
(d) The company should disclose the profit of ₹ 20 lakhs in notes to accounts.

**Ans: (c)**

# CHAPTER 7.2: AS 5- NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS & CHANGES IN ACCOUNTING POLICIES

**CONCEPTS OF THIS CHAPTER**

- Net Profit or Loss for the Period
- Extraordinary Items
- Profit/Loss from Ordinary Activities
- Prior Period Items.
- Changes in Accounting Estimates
- Changes in Accounting Policies

LDR

**LDR Questions**
**Q 12**

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Ordinary 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.

| | |
|---|---|
| **Disclosure** | 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 performance of entity, Nature and amount of such items should be disclosed separately. |
| **Special disclosure** | • Write-down of inventories to net realisable value as well as the reversal of such write-downs<br>• Restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring<br>• Disposals of items of fixed assets and long-term investments<br>• Legislative changes having retrospective application<br>• Litigation settlements and other reversals of provisions |

### 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
- Disclosed in the statement of profit and loss
  - As a part of net profit or loss for the period
  - Nature and amount of each item separately disclosed
  - in a manner that its impact on current profit or loss can be perceived.

### Prior Period Items

| | |
|---|---|
| • Are income or expenses | • Which arise in the current period as a result of |
| • Errors or omissions → | Errors may occur as a result of mathematical mistakes, periods. mistakes in applying accounting policies, misinterpretation of facts, or oversight |
| • In the preparation of the financial statements → | Of one or more prior periods. |

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived

### Changes in Accounting Estimates

An estimate may have to be revised consequent to changes occurring in the circumstances based on which the estimate was made, or new information, more experience or subsequent developments.

Revision of an estimate is neither an extraordinary item nor a prior period item.

**Effect of a change in an accounting estimate**

| | | |
|---|---|---|
| • **Included in the determination of net profit or loss** | Period of the change | if the change affects the period only. |
| | Period of the change and future periods | if the change affects both periods. |
| • **Classification in statement of profit and loss** | Using same classification as was used previously for the estimate. | |
| • **Disclosure** | Nature and amount need to be disclosed | which has a material effect in the current period. |
| | | or expected to have a material effect in subsequent periods |

**Accounting Policies**

| | | | |
|---|---|---|---|
| • **Can be changed only** | When the adoption of a different accounting policy is required by statute; or | For compliance with an accounting standard; or | When it is considered that the change would result in a more appropriate presentation of the financial statements of the Enterprise. |
| • **Conditions wherein there are no changes in accounting policies** | Adoption of an accounting policy for events or transactions that differ in substance from Previously occurring events or transactions, | Adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial. | |
| • **Disclosure** | Any change in accounting period which has material effect should be disclosed | The impact of, and the adjustments resulting from, such change, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. | |



## Question & Answers

### Question 1

**Explain whether the following will constitute a change in accounting policy or not as per AS 5:**

**(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.**

**(ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organistaion. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization. *(RTP Sep'24)***

**Answer 1**

As per para 31 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

(i) Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.

(ii) Similarly, the adoption of a new accounting policy of paying pension to retired employees is a policy for events or transactions which did not occur previously. Hence, it will not be treated as a change in an accounting policy.

### Question 2

**The accountant of Beryl Limited has asked you to identify the following items as – Change in Accounting Policies / Change in Accounting Estimates / Extraordinary Items / Prior period items / Ordinary Activity:**

**(i) Non-provision for salary already due in earlier year.**

**(ii) Attachment of the property of the enterprise.**

**(iii) Introduction of new pension scheme for employees.**

**(iv) Change in Reserve for obsolete inventory.**

**(v) Settlement of litigation case.**

(vi) **Actual Bad debts exceeds the provision.**
(vii) **Legislative changes having long term retrospective application.**
(viii) **Capitalisation of working capital loan interest.**
(ix) **Change from Cost Molde to Revaluation Model for measurement of carrying amount of PPE.**
(x) **Government sanctioned grant in current year for expenses incurred in previous accounting year. .**
***(PYP 5 Marks Nov'23)***

**Answer 2**

(i) Prior Period item
(ii) Attachment of property of enterprise is an extraordinary item.
(iii) Introduction of new pension scheme for employes is not a change in accounting policy. It is an ordinary activity.
(iv) Change in provision for obsolete inventory is a change in accounting estimate.
(v) Litigation settlement is an ordinary activity but requires separate disclosure
(vi) Change in estimate
(vii) Ordinary activity requiring separate disclosure
(viii) Error*
(ix) Change in Accounting policy.
(x) Ordinary activity requiring separate disclosure or extra-ordinary item.

**EXAM INSIGHTS:** The answers provided by most examinees indicated a lack of knowledge of the provisions of AS 5 while differentiating between activities mentioned therein. They were unable to classify specific items or activities correctly as prior period, extraordinary, Ordinary, Changes in accounting Estimates or changes in accounting policy as per the provisions of AS 5.

## Question 3

**EXOX Ltd. is in the process of finalizing its accounts for the year ended 31 st March, 2017. The company seeks your advice on the following:**

**(i) The Company's sales tax assessment for assessment year 2014-15 has been completed on 14th February, 2017 with a demand of Rs. 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.**

**(ii) The Company has entered into a wage agreement in May, 2017 whereby the labour union has accepted a revision in wage from June, 2016. The agreement provided that the hike till May, 2017 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2017.**

**You required to examine and give suggestions in line with the relevant Accounting Standards.**
***(MTP 5 Marks Apr'19, RTP May'21)***

**Answer 3**

(i) Since the company is not appealing against the addition of Rs. 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 2017. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed along with the contingent liability of Rs. 2.10 crore.
(ii) The arrears for the period from June, 2016 to March, 2017 are required to be provided for in the accounts of the company for the year ended on 31st March, 2017.

## Question 4

**Vivit Su Ltd. has a vacant land measuring 20,000 sq. m, which it had no intention to use in the future. The Company decided to sell the land to tide over its liquidity problems and made a profit of Rs.10 Lakhs by selling the said land. Moreover, there was a fire in the factory and a part of the unused factory shed valued at Rs. 8 Lakhs was destroyed. The loss from fire was set off against the profit from sale of land and profit of Rs. 2 lakhs was disclosed as net profit from sale of assets.**

**You are required to examine the treatment and disclosure done by the company and advise the company in line with AS 5. *(RTP May'18 & Nov'22)***

**Answer 4**

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

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

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

## Question 5

**The management of Pluto Limited has sought your opinion with relevant reasons, whether the following transactions will be treated as changes in Accounting Policy or not for the year ended 31st March, 2021. Please advise them in the following situations in accordance with the provisions of Accounting Standard 5:**

(i) **During the year ended 31st March, 2021, the management has introduced a formal retirement gratuity scheme in place of ad-hoc ex-gratia payments to its employees on retirement.**

(ii) **Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees would receive a pension of ₹ 25,000 per month. Earlier there was no such scheme of pension in the organization.**

(iii) **Provision for doubtful Trade Receivables was created @2.5% till 31st March 2020. From 1st April,2020, the rate of provision has been changed to 5%**

(iv) **For the year ended 31st March,2021 there was change in the cost formula in measuring the cost of Inventories.**

(v) **Till the end of the previous year, Computers were depreciated on Straight Line Basis over a period of 5 years. From current year, the useful life of Computers has been changed to 3 years.**
***(MTP 5 Marks Oct'22)***



**Answer 5**

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

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

(iii) In the given case, company has created 2.5 % provision for doubtful debts till 31st March, 2020. Subsequently from 1st April, 2020, the company revised the estimates based on the changed circumstances and wants to create 5% provision. Thus change in rate of provision of doubtful debt is change in estimate and is not change in accounting policy. This change will affect only current year.

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

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

## Question 6

**S.T.B. Ltd. makes provision for expenses amounting Rs. 7,00,000 as on March 31, 2020, but the actual expenses during the year ending March 31, 2021 comes to Rs. 9,00,000 against provision made during the last year. State with reasons whether difference of Rs. 2,00,000 is to be treated as prior period item as per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' *(MTP 5 Marks Apr'21)***

**Answer 6**

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 Rs. 2 lakhs, is not a prior period item. Therefore, in the given case expenses amounting Rs. 2,00,000 (i.e. Rs. 9,00,000 – Rs. 7,00,000) recorded in the current year, should not be regarded as prior period item.

## Question 7

**A company created a provision of Rs. 7,50,000 for staff welfare while preparing the financial statements for the year 2020-21. On 31st March 2021, in a meeting with staff welfare association, it was decided to increase the amount of provision for staff welfare to Rs. 10,00,000. The accounts were approved by Board of Directors on 15th April, 2021. You are required to explain the treatment of such revision in financial statements for the year ended 31st March 2021 in line with the provisions of AS 5?**
***(MTP 4 Marks Mar'21, MTP 5 Marks Apr'22)***

**Answer 7**

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the change in amount of staff welfare provision amounting Rs. 2,50,000 is neither a prior period item nor an extraordinary item. It is a change in estimate, which has been occurred in the year 2020-21.

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

## Question 8

**During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company's accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write it back to the Profit and Loss account as a prior period item.**

**Is the company's proposed accounting treatment correct? Discuss. *(RTP Jan'25)***

**Answer 8**

The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", refer only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The balance amount left in the provision created earlier is not as a result of error in the past. So it will not be considered as prior period item. Such write back of provision is not an ordinary feature of the business, it shall be considered as an extra-ordinary item.

As per paragraph 8 of AS 5, extraordinary items should be disclosed in the Statement of Profit and Loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the Statement of Profit and Loss in a manner that its impact on current profit or loss can be perceived. Hence, the amount so written-back (if material) should be disclosed as an extraordinary item as per AS 5 rather than as prior period items.

## Question 9

**a) There was a major theft of stores valued at Rs. 10 lakhs in the preceding year which was detected only during current financial year (2020-2021). How will you deal with this information in preparing the**

financial statements of R Ltd. for the year ended 31st March, 2021.

b) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organization. Such employees will get pension of Rs. 20,000 per month. Earlier there was no such scheme of pension in the organization. Explain whether this will constitute a change in accounting policy or not as per AS 5. *(RTP Nov'21, May'20)*

**Answer 9**

a) Due to major theft of stores in the preceding year (2019-2020) which was detected only during the current financial year (2020–2021), there was overstatement of closing inventory of stores in the preceding year. This must have also resulted in the overstatement of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year as 'Prior Period Items' as per AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. Accordingly, the adjustments relating to both opening inventory of the current year and profit brought forward from the previous year should be separately disclosed in the statement of profit and loss together with their nature and amount in a manner that their impact on the current profit or loss can be perceived. Alternatively, it may be assumed that in the preceding year, the value of inventory of stores as found out by physical verification of inventories was considered in the preparation of financial statements of the preceding year. In such a case, only the disclosure as to the theft and the resulting loss is required in the notes to the accounts for the current year i.e, year ended 31st March, 2021.

b) As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy. Accordingly, the adoption of a new accounting policy of paying pension to retired employees is a policy for events or transactions which did not occur previously. Hence, it will not be treated as a change in an accounting policy.

## Question 10

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

(i) **Actual bad debts turning out to be more than provisions.**
(ii) **Change from Cost model to Revaluation model for measurement of carrying amount of PPE.**
(iii) **Government grant receivable as compensation for expenses incurred in previous accounting period.**
(iv) **Treating operating lease as finance lease.**
(v) **Capitalization of borrowing cost on working capital.**
(vi) **Legislative changes having long term retrospective application.**
(vii) **Change in the method of depreciation from straight line to WDV.**
(viii) **Government grant becoming refundable.**
(ix) **Applying 10% depreciation instead of 15% on furniture.**
(x) **Change in useful life of fixed assets.** *(RTP May'23, PYP 5 Marks Jan'21)*

**Answer 10**

**Classification of given items is as follows:**

| Sr. No. | Particulars | Remarks |
|---|---|---|
| (i) | Actual bad debts turning out to be more than provisions | Change in Accounting Estimates |
| (ii) | Change from Cost model to Revaluation model for measurement of carrying amount of PPE | Change in Accounting Policy |
| (iii) | Government grant receivable as compensation for expenses incurred in previous accounting period | Extra -ordinary Items |
| (iv) | Treating operating lease as finance lease. | Prior- period Items |
| (v) | Capitalization of borrowing cost on working capital | Prior-period Items (as interest on working capital loans is not eligible for capitalization) |
| (vi) | Legislative changes having long term retrospective application | Ordinary Activity |
| (vii) | Change in the method of depreciation from straight line to WDV | Change in Accounting Estimates |

| | | |
|---|---|---|
| (viii) | Government grant becoming refundable | Extra -ordinary Items |
| (ix) | Applying 10% depreciation instead of 15% on furniture | Prior- period Items |
| (x) | Change in useful life of fixed assets | Change in Accounting Estimates |

## Question 11

**TQ Cycles Ltd. is in the manufacturing of bicycles, a labour intensive manufacturing sector. In April 2022, the Government enhanced the minimum wages payable to workers with retrospective effect from the 1st January,2022. Due to this legislative change, the additional wages for the period from January 2022 to March 2022 amounted to ₹ 30 lakhs. The management asked the Finance manager to charge ₹ 30 lakhs as prior period item while finalizing financial statements for the year 2022-23. Further, the Finance manager is of the view that this amount being abnormal should be disclosed as extra-ordinary item in the Profit and loss account for the financial year 2021-22. Discuss with reference to applicable Accounting Standards. *(PYP 5 Marks May'22)***

**Answer 11**

As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances which though related to prior periods, are determined in the current period. It is given that revision of wages took place in April, 2022 with retrospective effect from 1st January, 2022. Therefore, wages payable for the period from 1 01.2022 to 31.3.2022 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item. The full amount of wages payable to workers will be treated as an expense of current year and it will be charged to profit & loss account for the year 2022-23 as normal expenses.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Such an expense does not qualify as an extraordinary item. Therefore, finance manager is incorrect in treating increase as extraordinary item. However, as per AS 5, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Therefore, additional wages liability of ₹ 30 lakhs should be disclosed separately in the financial statements of TQ Cycles Ltd. for the year ended 31st March, 2023.

**EXAM INSIGHTS**: Most of the examinees were not able to give the correct treatment with reasoning thereof for the situation given in the question in line with the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies".

## Question 12

LDR

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

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

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

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

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

(v) **During the year ended 31st March, 2020, there was change in cost formula in measuring the cost of inventories. *(MTP 5 Marks Oct'19, May'20, Mar'19, Oct'18, SM, RTP May'22, RTP Nov'18, RTP Nov'19, RTP Nov'20, RTP May'20, PYP 5 Marks Nov'22)***

**Answer 12**

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

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

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

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

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

**EXAM INSIGHT**: Most of the examinees failed to explain the treatment of given transactions as change in Accounting Policies or change in Accounting Estimates in accordance with the provisions of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies"

## Multiple Choice Questions (MCQs)

**1. A change in the estimated life of the asset, which necessitates adjustment in the depreciation is an example of *(SM)***

(a) Prior period item.
(b) Ordinary item.
(c) Extraordinary item.
(d) Change in accounting estimate.

**Ans: (d)**

**2. Which of the following is considered as an extraordinary item as per AS 5? *(SM)***

(a) Write down or write-off of receivables, inventory and intangible assets.
(b) Gains and losses from sale or abandonment of equipment used in a business.
(c) Effects of a strike, including those against competitors and major suppliers.
(d) Flood damage from unusually heavy rain or a normally dry environment.

**Ans: (d)**

**3. Which one of the following is an example of extraordinary item? *(SM)***

(a) The write down of inventories to their net realisable value
(b) Reversal of write down of inventories
(c) Government grants become refundable
(d) Reversal of provisions.

**Ans: (c)**

**4. Extraordinary items are income or expenses *(SM)***

(a) That arise from events clearly distinct from the ordinary activities of the enterprise.
(b) That are not expected to recur frequently or regularly.
(c) Both (a) and (b).
(d) None of the three.

**Ans: (c)**

**5. An audit stock verification during the year ended 31st March, 20X1 revealed that opening stock of the year was understated by ₹ 5 lakhs due to wrong counting. While finalizing accounts, your opinion will be *(SM)***

(a) It is not a prior period item and no separate disclosure is required
(b) It should be treated as a prior period adjustment and should be separately disclosed in the current year's financial statement
(c) The adjustment of ₹ 5 lakhs in both opening stock of current year and profit brought forward from previous year should be made
(d) Both (b) and (c).

**Ans: (d)**

B

# CHAPTER 7.3: AS 11 THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

**CONCEPTS OF THIS CHAPTER**

- Foreign Currency Transactions
- Subsequent Reporting
- Integral & Non-Integral Operations
- Disposal of Non-integral Operations
- Net Investment in Non-integral Foreign Operation.
- Initial Recognition
- Exchange Differences
- Change in Classification
- Forward Exchange Contracts

LDR

**LDR Questions**
**Q 14**

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Initial Recognition** -A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

**Reporting of Foreign currency items**

| Monetary | Non-monetary | | |
|---|---|---|---|
| Reported using the closing rate. | **Carried in terms of Historical cost denominated in a foreign currency-** Reported using the exchange rate at the date of the transaction. | **Carried at fair value or other similar valuation denominated in a foreign currency-** Reported using the exchange rates that Existed when the values were determined. | **Contingent liability Denominated in foreign currency-** Disclosed by using the closing rate |

**Translation of Integral Foreign Operations (IFO)**

- Individual items in financial statements of the foreign operation are translated as if the transactions were made by the reporting enterprise itself.
- Cost and depreciation of tangible fixed assets are translated using the exchange rate at the date of purchase or valuation.
- Inventory cost is translated at the exchange rate when costs were incurred..
- Recoverable or realizable value of an asset is translated using the exchange rate when it was determined.

**Translation of Non-Integral Foreign Operations (NFO)**

| Assets and Liabilities | Income and Expense Items | Resulting exchange differences | Any goodwill or capital reserve arising on the acqusition | A contingent liability disclosed in the financial statements |
|---|---|---|---|---|
| • Closing rate | • at exchange rates at the dates of the transactions | • should be accumulated in a foreign currency translation reserve until disposal of the net investment | • closing rate. | • closing rate* |

**Indications that an FO is a Non- Integral Foreign Operation rather than a Integral Foreign Operation**

| | |
|---|---|
| **Control** | RE may control the FOA of the FO are carried out with a significant degree of autonomy from those of the RE |
| **Transactions** | With the RE are not a high proportion of the FOA |
| **Finance** | FOA are financed mainly from its own operations or local borrowings rather than from RE |

| | |
|---|---|
| **Cost** | Costs of labour, material and other components of the FO'S products or services are primarily paid or settled in the local currency rather than in the RE currency |
| **Sales** | FO's sales are mainly in currencies other than the RE currency |
| **Cash Flows** | RE cash flows are insulated from the day-to-day activities of the FO rather than being directly affected by the FOA |
| **Sales prices** | Sales prices for the FO'S products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation. |
| **Local sales market** | There is an active local sales market for the FO'S products, although there also might be significant amounts of exports. |

RE - Reporting Enterprise | FO- Foreign Operation | FOA - Foreign Operation Activities

**Reclassification of Integral foreign operation to Non- integral foreign operation**

Exchange differences arising on the translation of non-monetary assets at the date of the reclassification accumulated in a foreign currency translation reserve

**Reclassification of Non- integral foreign operation to Integral foreign operation**

Translated amounts for non-monetary items at the date of the change. Treated as the historical cost for those items in the period of change and subsequent periods

Exchange Differences which have been deferred are not recognised as income or expenses until the disposal of the operation

**Forward exchange contract or another financial instrument**

| | | |
|---|---|---|
| **Not intended for trading or speculation purposes** | Premium or discount | Amortised as expense or income over the life of the contract |
| | Exchange differences | Recognised in the statement of profit and loss in the reporting period in which the exchange rates change. |
| | Cancellation or renewal of contract | Recognised as income or as expense for the period. |
| **Intended for trading or speculation purposes** | Premium or discount | Ignored |
| | Contract Value | Marked to its current market value at each balance sheet date |
| | Gain or loss | Recognised. |

**Disclosure**

| | |
|---|---|
| Exchange differences Amount | Included in the net profit or loss for the period |
| | Accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period. |
| Reporting currency | Reason for using a different currency (in which the enterprise is domiciled) |
| | Reason for any change in the reporting currency |
| Change in the classification of a significant foreign operation | Nature of the change in classification |
| | Reason for the change |
| | Impact of the change in classification on shareholders' funds; and |
| | Impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented. |

## Question & Answers

### Question 1

**Explain "monetary item" as per Accounting Standard 11.**
**How are foreign currency monetary items to be recognized at each Balance Sheet date?**
**Classify the following as monetary or non-monetary item:**
**Share Capital.**
**Trade Receivables.**
**Investments.**
**Fixed Assets.** ***(RTP Nov'23) (MTP 5 Marks Nov '21, April '23 & SM)***

**Answer 1**

As per AS 11, Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Foreign currency monetary items should be reported using the closing rate at each balance sheet date. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realized from, or required to disburse, a foreign currency monetary item at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to disburse, such item at the balance sheet date.

Classification of items as monetary or non-monetary item:

Share capital- Non-monetary

Trade receivables- Monetary

Investments- Non-monetary

Fixed Assets (PPE)- Non-monetary

## Question 2

**Assets and liabilities and income and expenditure items in respect of integral foreign operations are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to revenue. You are required to comment in line with AS 11.** ***(MTP 5 Marks Oct '22, RTP May'20, SM)***

**Answer 2**

Financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures of AS 11 (Revised 2003). The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. The foreign currency monetary items (for example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange date at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate. Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account.

Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11 (Revised 2003).

## Question 3

**(a) Classify the following items into Monetary and Non-monetary:**

**(i) Share capital; (ii) Trade Payables; (iii) Cash balance; (iv) Property, plant and equipment**

**(b) Trade payables of CAT Ltd. include amount payable to JBB Ltd., Rs. 10,00,000 recorded at the prevailing exchange rate on the date of transaction, transaction recorded at US $1 = Rs. 80.00. The exchange rate on balance sheet date (31.03.2020) was US $1 = Rs. 85.00. You are required to calculate the amount of exchange difference and also explain the accounting treatment needed for this as per AS 11 in the books of CAT Ltd.** ***(RTP May'21)***

**Answer 3**

**(a)** Share capital - Non-monetary; Trade Payables - Monetary

Cash balance – Monetary; Property, plant and equipment - Non-monetary

**(b) Amount of Exchange difference and its Accounting Treatment**

| | Foreign Currency Rate | Rs. |
|---|---|---|
| **Trade payables** | | |

| | | |
|---|---|---|
| Initial recognition US $ 12,500 (Rs.10,00,000/80) | 1 US $ = Rs. 80 | 10,00,000 |
| Rate on Balance sheet date | 1 US $ = Rs. 85 | |
| Exchange Difference loss US $ 12,500 x Rs. (85-80) | | 62,500 |
| Treatment: Debit Profit and Loss A/c by Rs. 62,500 and Credit Trade Payables | | |

Thus, Exchange Difference on trade payables amounting Rs. 62,500 is required to be transferred to Profit and Loss.

## Question 4

**A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2022, when the exchange rate was ₹ 43 per US Dollar. The company had recorded the transaction in the books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2022 when the exchange rate was ₹ 47 per US Dollar. However, on 31st March, 2022, the rate of exchange was ₹ 48 per US Dollar. The company passed an entry on 31st March, 2022 adjusting the cost of raw materials consumed for the difference between ₹ 47 and ₹ 43 per US Dollar. In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss *(RTP Nov'22)***

**Answer 4**

As per AS 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', monetary items denominated in a foreign currency should be reported using the closing rate at each balance sheet date. The effect of exchange difference should be taken into profit and loss account. Trade payables is a monetary item, hence should be valued at the closing rate i.e, ₹ 48 at 31st March, 2022 irrespective of the payment for the same subsequently at lower rate in the next financial year. The difference of ₹ 5 (₹ 48-₹ 43) per US dollar should be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2022 and is not to be adjusted against the cost of raw materials. In the subsequent year, the company would record an exchange gain of ₹ 1 per US dollar, i.e., the difference between ₹ 48 and ₹ 47 per US dollar. Hence, the accounting treatment adopted by the company is incorrect.

## Question 5

**Trade Payables of Jared Limited includes amount due to Sterling Limited ₹ 9,75,000 recorded at the prevailing exchange rate on the date of purchase; transaction recorded at US $ 1 = ₹ 75.00. The exchange rate on Balance Sheet date (31st March,2022) was US $ 1 = 79.00 The payment was made on 1st May,2022 when the exchange rate was US $ 1 = ₹ 78.30.**

**You are required to calculate the amount of exchange difference on 31st March, 2022 and 1st May, 2022 and also explain the accounting treatment needed in the above case as per AS 11 in the books of Jared Limited. *(PYP 2.5 Marks Nov'22)***

**Answer 5**

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.

| Trade payables | Foreign Currency Rate | Amount ₹ |
|---|---|---|
| Initial recognition US $13,000 (9,75,000/75) | 1 US $ = ₹ 75 | |
| Exchange Rate on Balance sheet date | 1 US $ = ₹ 79 | |
| Exchange Difference Loss US $ 13,000 X (79-75) | | 52,000 |
| Exchange Rate on Settlement date | 1 US $ = ₹ 78.30 | |
| Exchange Difference Profit US $ 13,000 x (79-78.30) | | 9,100 |

For the year ended 31st March, 2022 exchange difference loss amounting ₹ 52,000 will be charged to statement of Profit & Loss A/c. However, there is exchange difference gain of ₹ 13,000 x (79-78.30) = 9,100 on 1st May, 2022. Thus gain of ₹ 9,100 will be credited to statement of Profit & Loss A/c for the year ended 31st March, 2023.

**EXAM INSIGHTS:** Some of the examinees were not able to correctly compute the amount of premium on forward contract to be debited to Profit and Loss Account. Many of them committed error in transferring foreign exchange loss /profit on trade payables transferred to profit and loss account for the financial years ended 31st March, 2022 and 2023 in line with the provisions of AS 11, "The Effects of Changes in Foreign Exchange Rates".

## Question 6

**Rau Ltd. purchased a plant for US$ 1,00,000 on 01st February 2020, payable after three months. Company entered into a forward contract for three months @ Rs. 49.15 per dollar. Exchange rate per dollar on 01st Feb. was Rs. 48.85. How will you recognize the profit or loss on forward contract in the books of Rau Ltd.? *(MTP 5 Marks, May'20, RTP Nov'21, RTP May'19, SM) (Same concept different figures PYP 2.5 Marks Nov'22)***

**Answer 6**

| | |
|---|---|
| Forward Rate | Rs. 49.15 |
| Less: Spot Rate | (Rs. 48.85) |
| Premium on Contract | Rs. 0.30 |
| Contract Amount | US$ 1,00,000 |
| Total Loss (1,00,000 x 0.30) | Rs. 30,000 |

Contract period 3 months

Two months falling in the year ended 31st March, 2020; therefore, loss to be recognized (30,000/3) x 2 = Rs. 20,000. Balance amount of Rs. 10,000 will be recognized in the following financial year.

## Question 7

**ABC Ltd. borrowed US $ 5,00,000 on 01/01/2021, which was repaid as on 31/07/2021. ABC Ltd. prepares financial statement ending on 31/03/2021. Rate of Exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:**

| | | |
|---|---|---|
| 01/01/2021 | 1 US$ = | ₹ 68.50 |
| 31/03/2021 | 1 US $ = | ₹ 69.50 |
| 31/07/2021 | 1 US $ = | ₹ 70.00 |

**You are required to pass necessary journal entries in the books of ABC Ltd. as per AS 11.**
***(MTP 5 Marks, Sep'22, PYP May'18, 5 Marks) (Same concept different figures as SM)***

**Answer 7**

**Journal Entries in the Books of ABC Ltd.**

| Date | Particulars | | ₹ (Dr.) | ₹ (Cr.) |
|---|---|---|---|---|
| Jan. 01, 2021 | Bank Account (5,00,000 x 68.50) | Dr. | 342,50,000 | |
| | To Foreign Loan Account | | | 342,50,000 |
| March 31, 2021 | Foreign Exchange Difference Account | Dr. | 5,00,000 | |
| | To Foreign Loan Account [5,00,000 x (69.50-68.50)] | | | 5,00,000 |
| Jul. 31, 2021 | Foreign Exchange Difference Account [5,00,000 x (70-69.5)] | Dr. | 2,50,000 | |
| | Foreign Loan Account | Dr. | 347,50,000 | |
| | To Bank Account | | | 350,00,000 |

## Question 8

**ABC Builders Limited had borrowed a sum of US $ 15,00,000 at the beginning of Financial year 2020-21 for its residential project at London Interbank Offered Rate (LIBOR) + 4 %. The interest is payable at the end of the Financial Year. At the time of availing the loan, the exchange rate was ₹ 72 per US $ and the rate as on 31st March, 2021 was ₹ 76 per US $. If ABC Builders Limited borrowed the loan in Indian Rupee equivalent, the pricing of loan would have been 9.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2021 as per applicable Accounting Standards. (Applicable LIBOR is 1%). *(RTP May'23)***

**Answer 8**

(i) Interest for the period 2020-21
= US $ 15 lakhs x 5% × ₹ 76 per US $ = ₹ 57 lakhs

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

(iii) Interest that would have resulted if the loan was taken in Indian currency
= US $ 15 lakhs × ₹ 72 x 9.5% = ₹ 102.60 lakhs

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = ₹ 102.60 lakhs less ₹ 57 lakhs = ₹ 45.60 lakhs.

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

## Question 9

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

**(ii) Trade receivable includes amount receivable from Prakash Ltd., Rs. 10,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = Rs. 59.00. The exchange rate on balance sheet data (31.03.2018) was US $1 = Rs. 62.00.**

**You are required to calculate the amount of exchange difference and also explain the accounting treatment needed in the above two cases as per AS 11 in the books of ABC Ltd.**

***(PYP Nov'18, 5 Marks) (Same concept different figures -PYP Dec'21 5 Marks, MTP 5 Marks Apr'23)***

**Answer 9**

**Amount of Exchange difference and its Accounting Treatment**

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

Thus, Exchange Difference on Long term loan amounting Rs. 1,00,000 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on trade receivables amounting Rs. 50,847.456 is required to be transferred to Profit and Loss A/c.

**EXAM INSIGHTS:** Few of the examinees failed to calculate the amount of exchange difference and unable to explain the accounting treatment as per AS 11, "The Effects of Changes in Foreign Exchange rates". Some of them only quote that the difference to be debited to P & L A/c without mentioning the alternative. Where the difference can be transferred to foreign Currency Monetary Item Translation Difference Account.

## Question 10

**Bansal Company Ltd. imported raw material worth US Dollars 12,000 on 15th January, 2024 when the exchange rate was ₹ 68 per US Dollar. The payment for the transaction was made on 5th May, 2024 when exchange rate was ₹ 64 per US Dollar. At the year end, 31st March, 2024, the rate of exchange was ₹ 65 per US Dollar. The accountant of the company passed entry on 31st March, 2024 adjusting the cost of raw material consumed for the difference between ₹ 64 and ₹ 68 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11 (Revised).** ***(RTP Jan'25)***

**Answer 10**

As per AS 11, 'The Effects of Changes in Foreign Exchange Rates', initial recognition of a foreign currency transaction is done in the reporting currency by applying the exchange rate at the date of the transaction. Accordingly, on 15th January, 2024, the raw material purchased and its creditors will be recorded at US dollar 12,000 × ₹ 68 = ₹ 8,16,000.

Also, on balance sheet date such transaction is reported at closing rate of exchange, hence it will be valued at the closing rate i.e. ₹ 65 per US dollar (USD 12,000 x ₹ 65 = ₹ 7,80,000) at 31st March, 2024, irrespective of the payment made for the same subsequently at lower rate in the next financial year.

The difference of ₹ 3 (65 – 68) per US dollar i.e. ₹ 36,000 (USD 12,000 x ₹ 3) will be shown as an exchange gain in the profit and loss account for the year ended 31st March, 2024 and will not be adjusted against the cost of raw materials.

In the subsequent year on settlement date, the company would recognize or provide in the Profit and Loss account an exchange gain of ₹ 1 per US dollar, i.e. the difference from balance sheet date to the date of settlement between ₹ 65 and ₹ 64 per US dollar i.e. ₹ 12,000.

Hence, the accounting treatment adopted by the Accountant of the company is incorrect i.e. it is not in accordance with the provisions of AS 11.

## Question 11

**Alfa Ltd. purchased an item of property, plant and equipment for US $ 50 lakh on 01.04.2023 and the same was fully financed by the foreign currency loan [i.e. US $] repayment in five equal instalments annually. (Exchange rate at the time of purchase was 1 US $ = ₹ 60]. As on 31.03.2024 the first instalment was paid when 1 US $ fetched ₹ 62.00. The entire loss on exchange was included in cost of goods sold. Alfa Ltd. normally provides depreciation on an item of property, plant and equipment at 20% on WDV basis and exercised the option to adjust the cost of asset for exchange difference arising out of loan restatement and payment. Calculate the amount of exchange loss and its treatment and depreciation.** ***(RTP Sep'24) . (MTP 5 Marks Oct'20, Oct'21)***

**Answer 11**

Exchange differences arising on restatement or repayment of liabilities incurred for the purpose of acquiring an item of property, plant and equipment should be adjusted in the carrying amount of the respective item of property, plant and equipment as Alfa Ltd. has exercised the option and it is long term foreign currency monetary item.

Thus, the entire exchange loss due to variation of ₹ 20 lakh on 31.03.2023 on payment of US $ 10 lakh, should be added to the carrying amount of an item of property, plant and equipment and not to the cost of goods sold. Further, depreciation on the unamortized depreciable amount should also be provided.

Calculation of Exchange loss:

Foreign currency loan (in ₹) = (50 lakh $ x ₹ 60) = ₹ 3,000 lakh

Exchange loss on outstanding loan on 31.03.2024 = ₹ 40 lakh US $ x (62.00-60.00) = ₹ 80 lakh.

So, ₹ 80 lakh should also be added to cost of an item of property, plant and equipment with corresponding credit to outstanding loan in addition to ₹ 20 lakh on account of exchange loss on payment of instalment. The total cost of an item of property, plant and equipment to be increased by ₹ 100 lakh.

Total depreciation to be provided for the year 2023 - 2024 = 20% of (₹ 3,000 lakh + 100 lakh) = ₹ 620 lakh.

## Question 12

**Wiwitzu Ltd. borrowed US $ 3,00,000 on 31-12-2020 which will repaid as on 30-06-2021. Wiwitzu Ltd. prepares its financial statements ending on 31-03-2021. Rate of exchange between reporting currency (Rupee) and foreign currency (US$) on different dates are as under:**

| | |
|---|---|
| 31-12-2020 | 1 US $ = ₹ 44.00 |
| 31-03-2021 | 1 US $ = ₹ 44.50 |
| 30-06-2021 | 1 US $ = ₹ 44.75 |

(i) **Calculate Borrowings in reporting currency to be recognized in the books on above mentioned dates and also show journal entries for the same.**

(ii) **if borrowings were repaid on 28-2-2021 on which date exchange rate was 1 US $ = ₹ 44.20 then what entry should be passed?** ***(RTP May'22)***

**Answer 12**

(i) As per AS 11 'The Effect 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. Moreover, at each balance sheet date, foreign currency monetary items should be reported using the closing rate. Accordingly, on 31.12.2020 borrowings will be recorded at ₹ 1,32,00,000 (i.e., ₹ 3,00,000 × ₹ 44.00). On 31.3.2021 borrowings (monetary items) will be recorded at ₹ 1,33,50,000 (i.e. $ 3,00,000 × ₹ 44.50).

**Journal of Wiwitzu Ltd.**

| Date | Particular | | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| 31-12-2020 | Bank A/c | Dr. | 1,32,00,000 | |
| | To Foreign Loan Account | | | 1,32,00,000 |
| 31-03-2021 | Foreign Exchange Difference Account A/c | Dr. | 1,50,000 | |
| | To Foreign Loan Account | | | 1,50,000 |
| 30-06-2021 | Foreign Loan Account A/c | Dr. | 1,33,50,000 | |
| | Foreign Exchange Difference Account A/c | | 75,000 | |
| | To Bank A/c | | | 1,34,25,000 |

**(ii) In case borrowings were repaid before Balance Sheet Date, then the entry would be as follows:**

| Date | Particular | | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| 28-02-2021 | Foreign Loan Account A/c | Dr. | 1,32,00,000 | |
| | Foreign Exchange Difference Account A/c | Dr. | 60,000 | |
| | To Bank A/c | | | 1,32,60,000 |

**Working Notes:**

(i) The exchange difference of ₹ 1,50,000 is arising because the transaction has been reported at different rate (₹ 44.50 = 1 US $) from the rate initially recorded (i.e., ₹ 44 = 1 US $) from the rate initially recorded (i.e., ₹ 44 = 1 US $)

(ii) The exchange difference of ₹ 75,000 is arising because the transaction has been settled at an exchange rate (₹ 44.75 = 1 US$) different from the rate at which reported in the last financial statements (₹ 44.50 = 1 US$).

(iii) The exchange difference of ₹ 60,000 is arising because the transaction has been settled at a different rate (i.e., ₹ 44.20 = 1 US $) than the rate at which initially recorded (1 US $ = ₹ 44.00)

## Question 13

**Karna Ltd., an Indian Company, has the following foreign currency transactions during the financial year 2022-23:**

**(i) On 1st July, 2022, imported goods from Try Ltd., a German based company, amounting to ₹ 30,96,000.**

**(ii) On 1st October, 2022, imported plant and machinery from Lucy Ltd., a German based company, for € 18,500. The amount was paid on the date of import itself. (Ignore depreciation).**

**(iii) On 1st December, 2022, exported good on credit to Cream Ltd., a German based company, amounting to ₹ 50,40,000.**

**All the above transactions were recorded in the books of account at the prevailing exchange rate on the date of the transactions. Ignore taxes and duty on the above transactions.**

**Payment due from Cream Ltd. and payment due to Try Ltd. is outstanding as on 31st March, 2023.**

**Rate of exchange between reporting currency (₹) and foreign currency (€) on different dates are as under:**

| | |
|---|---|
| **On 1st July, 2022** | **1 € = ₹ 86** |
| **On 1st October, 2022** | **1 € = ₹ 88** |
| **On 1st December, 2022** | **1 € = ₹ 84** |
| **On 31st March, 2023** | **1 € = ₹ 90** |

**You are required, as per AS-11:**

**(i) To show value at which above items will appear in Balance sheet as on 31st March, 2023;**

**(ii) To calculate the amount of gain/loss on each of above transactions on account of exchange differences, if any.** ***(PYP 5 Marks Nov'23)***

**Answer 13**

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", Foreign currency monetary items should be reported using the closing rate. Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

**(i) Items given in the question will appear in the Balance Sheet at the following values:**

Trade Payables (30,96,000/86= 36,000 German Currency) x ₹ 90 = ₹ 32,40,000
Plant and Machinery 18,500 German Currency X ₹ 88 = ₹16,28,000
Trade Receivables (50,40,000/84= 60,000 German Currency) x ₹ 90 = ₹ 54,00,000

**(ii) Amount of gain / loss on each transaction on account of exchange difference:**

Exchange loss on Transaction of import of goods from Try Ltd. = ₹ (1,44,000)
[36,000 German Currency X ₹ 4 (i.e. 90-86)]
Exchange gain on Transaction of export of goods to Cream Ltd = ₹ 3,60,000
[60,000 German Currency X ₹ 6 (i.e. 90-84)]

**EXAM INSIGHTS:** Most of the examinees failed to differentiate between monetary and non-monetary items. They also failed to calculate the loss /gain on account of exchange differences.

## Question 14

LDR

**Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.03.2020**

**(i) Debtors include amount due from Mr. S ₹ 9,00,000 recorded at the prevailing exchange rate on the date of sales, transaction recorded at US $1 = ₹ 72.00**

**US $ 1=₹ 73.50 on 31st March,2020**

**US $ 1= ₹ 72.50 on 1st April,2019.**

**(ii) Long term loan taken on 1st April, 2019 from a U.S. company amounting to ₹ 75,00,000. ₹ 5,00,000 was repaid on 31st December, 2019, recorded at US $ 1 = ₹ 70.50. Interest has been paid as and when debited by the US company.**

**US $1= ₹ 73.50 on 31st March,2020**

**US $1=1₹ 72.50 on 1st April, 2019.** ***(PYP 5 Marks Jan'21) (Same concepts different figures SM)***

**Answer 14**

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.

| | Foreign Currency Rate | ₹ |
|---|---|---|
| Debtors | | |
| Initial recognition US $12,500 (9,00,000/72) | 1 US $ = ₹72 | 9,00,000 |
| Rate on Balance sheet date | 1 US $ = ₹ 73.50 | |
| Exchange Difference Gain US $ 12,500 X (73.50 - 72) | | 18,750 |
| Treatment: Credit Profit and Loss A/c by ₹ 18,750 | | |
| Long term Loan | | |
| Initial recognition US $ 1,03,448.28 (75,00,000/72.50) | 1 US $ = ₹ 73.50 | 75,00,000 |
| Rate on Balance sheet date | 1 US $ = ₹ 73.50 | |
| Exchange Difference Loss after adjustment of exchange gain on repayment of ₹ 5,00,000 | | |

| | | |
|---|---|---|
| ₹ 67,987.48 [82,171.88 (US $ 96,356.08 X ₹ 73.5 Less ₹ 70,00,000) less profit 14,184.40 [US $ 7,092.2 (5,00,000/70.5) X ₹ 2)] NET LOSS Treatment: Credit Loan A/c and Debit FCMITD A/C or Profit and Loss A/c by ₹ 67,987.48 | | 67,987.48* |

Thus, Exchange Difference on Long term loan amounting ₹ 67,987.48 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on debtors amounting ₹ 18,750 is required to be transferred to Profit and Loss A/c.

**NOTE 1:** *Exchange Difference Loss (net of adjustment of exchange gain on repayment of ₹ 5,00,000) has been calculated in the above solution. Alternative considering otherwise also possible.

**NOTE 2:** Date of sales transaction of ₹ 9 lakhs have not been given in the question and hence it has been assumed that the transaction took place during the year ended 31 March 2020.

## Question 15

**Trower Limited is an Indian importer. It imports goods from True View Limited situated at London. Trower Limited has a payable of £50,000 to True View Limited as on 31st March, 2023. True View Limited has given Trower Limited the following two options:**

**(i) Pay immediately with a cash discount of 1% on the payable.**

**(ii) Pay after 6 months with interest @ 5% p.a. on the payable.**

**The borrowing rate for Trower Limited in rupees is 15% p.a.**

**The following are the exchange rates:**

| Date | ₹ |
|---|---|
| 31st March,2023 | 97 |
| 30th September, 2023 | 99 |

**You are required to give your opinion to Trower Limited on which of the above two options to be chosen.** ***(PYP 5 Marks May'23)***



**Answer 15**

**Option (i) Pay immediately with Cash discount of 1% on the payable**

| | ₹ |
|---|---|
| Total amount payable as on 31.3.2023 (50,000 x ₹ 97) | 48,50,000 |
| Less: Cash discount | (48,500) |
| | 48,01,500 |
| Add: Borrowing cost @ 15% p.a. for 6 months | 3,60,112.50 |
| If payment made immediate | 51,61,612.50 |

**Option (ii) Pay after 6 months with interest @ 5% p.a. on the payable**

| | ₹ |
|---|---|
| Total amount payable as on 31.3.2023 (50,000 x ₹ 99) | 49,50,000 |
| Interest for 6 months @ 5% | 1,23,750 |
| If payment made after 6 months | 50,73,750 |

Thus, Option (ii) is beneficial to Trower Limited as the Rupee outflow will be lower by ₹ (51,61,612 – 50,73,750) = ₹ 87,862 in option (ii).

**Note:** The above answer be presented in the alternative manner given as below:

**Option (i) Pay immediately with Cash discount of 1% on the payable**

| | |
|---|---|
| Total amount payable on 31.3.2023 | 50,000 |
| Less: Cash discount (50,000 x 1 / 100) | (500) |
| | 49,500 |
| 49,500 x ₹ 97 | 48,01,500 |
| Add: Borrowing cost @ 15% p.a. for 6 months | 3,60,112 |

| | |
|---|---|
| If payment made immediate | ₹ 51,61,612 |

**Option (ii) Pay after 6 months with interest @ 5% p.a. on the payable**

| | ₹ |
|---|---|
| Total amount payable on 31.3.2023 | 50,000 |
| Interest for 6 months @ 5% (50,000 x 5 / 100 x 6 / 12) | 1.250 |
| | 51,250 |
| If payment made after 6 months (51,250 x 99) | 50,73,750 |

Thus, Option (ii) is beneficial to Trower Limited as the Rupee outflow will be lower by ₹ (51,61,612 – 50,73,750) = ₹ 87,862 in option (ii).

**EXAM INSIGHTS**: Few examinees were not able to give opinion for the payment to the importer reg. two options: (i) immediate payment (ii) payment after 6 months for import of goods based on the information given in the question.

**Multiple Choice Questions (MCQs)**

**1. As per AS 11 assets and liabilities of non-integral foreign operations shouldbe converted at rate.**

(a) Opening
(b) Average
(c) Closing
(d) Transaction

**Ans: (c)**

**2. The debit or credit balance of "Foreign Currency Monetary Item Translation Difference Account"**

(a) Is shown as "Miscellaneous Expenditure" in the Balance Sheet
(b) Is shown under "Reserves and Surplus" as a separate line item
(c) Is shown as "Other Non-current" in the Balance Sheet
(d) Is shown as "Current Assets" in the Balance Sheet

**Ans: (b)**

**3. If asset of an integral foreign operation is carried at cost, cost and depreciation of tangible fixed asset is translated at**

(a) Average exchange rate
(b) Closing exchange rate
(c) Exchange rate at the date of purchase of asset
(d) Opening exchange rate

**Ans: (c)**

**4. Which of the following can be classified as an integral foreign operation?**

(a) Branch office serving as an extension of the head office in terms of operations
(b) Independent subsidiary of the parent company
(c) Branch office independent of the head office in terms of operational decisions
(d) None of the above

**Ans: (a)**

**5. Which of the following items should be converted to closing rate for the purposes of financial reporting?**

(a) Items of Property, Plant and Equipment
(b) Inventory
(c) Trade Payables, Trade Receivables and Foreign Currency Borrowings
(d) All of the above

**Ans: (c)**

**6. The debit or credit balance of "Foreign Currency Monetary Item Translation Difference Account" *(RTP Jan'25)***

(a) Is shown as "Miscellaneous Expenditure" in the Balance Sheet
(b) Is shown under "Reserves and Surplus" as a separate line item
(c) Is shown as "Other Non-current" in the Balance Sheet
(d) Is shown as "Current Assets" in the Balance Sheet

**Ans: (b)**

A

# CHAPTER 7.4: AS 22 "ACCOUNTING FOR TAXES ON INCOME"

**CONCEPTS OF THIS CHAPTER**

- Objective of AS 22
- Recognition Criteria for Deferred Tax.
- Measurement of Deferred Tax
- Practical Problems
- Presentation and Disclosure
- Review of Deferred Tax Assets
- Re-assessment of Unrecognized Deferred Tax Assets

LDR

**LDR Questions**
**Q 11**

## QUICK REVIEW OF IMPORTANT CONCEPTS

| **Differences between taxable income and accounting income** | |
|---|---|
| Timing differences | Permanent differences |
| For a period that originate in one period and are capable of reversal in one or more subsequent periods. | For a period that originate in one period and do not reverse subsequently |

- **Accounting income (loss)**
  Net profit or loss for a period, as reported in the statement of profit and loss, before deducting income-tax expense or adding income tax saving
- **Taxable income (tax loss)**
  Amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income-tax payable (recoverable) is determined.
- **Tax expense(tax saving)**
  Aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.
- **Current tax**
  Amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.
- **Deferred tax-** Tax effect of timing differences.

### Recognition

- Tax expenses, including current and deferred tax, are part of net profit or loss.
- Permanent differences do not create deferred tax assets or liabilities.
- Taxes are accrued in the same period as related revenue and expenses, leading to timing differences.
- Tax effects of timing differences are recorded in the profit and loss statement and as deferred tax liabilities in the balance sheet.
- Deferred tax assets are recognized only when their realization is reasonably certain.

### Review Of Deferred Tax Assets

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

Disclosures

**Statement of profit and loss**

- Under AS22, there is no specific requirement to disclose current tax and deferred tax in the statement of profit and loss.
- Considering the requirements under the companies Act, 2013, the amount of income tax and other taxes on profits should be disclosed.
- AS 22 dose not require any reconciliation between accounting profit and the tax expense

**Balance sheet**

- The break-up deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts.
- Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.
- The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax low

## Question & Answers

### Question 1

**Can an enterprise offset deferred tax assets and deferred tax liabilities? If yes, prescribe the conditions required for such offset as per provisions of AS 22.? *(RTP Nov'21)***

**Answer 1**

Yes. It can offset deferred tax assets and deferred tax liabilities.

As per AS 22, an enterprise should offset deferred tax assets and deferred tax liabilities if:

(i) the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

(ii) the deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.



### Question 2

**Define followings as per AS 22:**

**(i) Accounting income (loss)**

**(ii) Taxable income (tax loss)**

**(iii) Tax expense (tax saving) *(RTP Nov'22)***

**Answer 2**

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

**Taxable income (tax loss)** is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income-tax payable (recoverable) is determined.

**Taxable expenses** is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

### Question 3

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

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

**You are required to show impact of the above items in terms of Deferred Tax Assets/Deferred Tax Liability for the year ended 31.03.2021. *(RTP May'22)***

**Answer 3**

**Impact of various items in terms of deferred tax liability/deferred tax asset as per AS 22**

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

## Question 4

**The following particulars are stated in the Balance Sheet of HS Ltd. as on 31 -3-2019 :**

| Particulars | (₹ in lakhs) |
|---|---|
| Deferred Tax Liability (Cr.) | 60.00 |
| Deferred Tax Assets (Dr.) | 30.00 |

**The following transactions were reported during the year 2019-20 :**

| | |
|---|---|
| Depreciation as per accounting records | 160.00 |
| Depreciation as per income tax records | 140.00 |
| Items disallowed for tax purposes in 2018-19 but allowed in 2019-20 | 20.00 |
| Donation to Private Trust | 20.00 |
| Tax rate | 30% |

**There were no additions to fixed assets during the year. You are required to show the impact of various items on Deferred Tax Assets and Deferred Tax Liability as on 31-3-2020 as per AS-22.**
***(PYP 5 Marks Jan'21, RTP May'20)***

**Answer 4**

Impact of various items in terms of AS 22 deferred tax liability/deferred tax asset

(1) Difference in Depreciation- Generally, written down value method of depreciation is adopted under income Tax Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years. It is timing difference for which reversal of Deferred tax liability is required.
Reversal of DTL= ₹ (160 – 140) Lakhs X 30% = ₹6 Lakhs

(2) Disallowances, as per IT Act of earlier years- Due to disallowance tax payable for the earlier years was higher on this account. It is responding timing difference which required Reversal of Deferred tax assets.
Reversal of Deferred tax assets = ₹20 Lakhs X 30% = ₹ 6 Lakhs

(3) Donations to private trusts is not an allowable expenditure under IT Act. It is permanent difference. Hence, no reversal of tax is required.

## Question 5

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

| Particulars | ₹ |
|---|---|
| Accounting profit | 15,00,000 |
| Book profit as per MAT | 7,50,000 |
| Profit as per Income tax Act | 2,50,000 |
| Tax Rate | 20% |
| MAT Rate | 7.5% |

**Calculate the deferred tax asset/liability as per AS 22 and amount of tax to be debited to the profit and loss account for the year.** ***(PYP 5 Marks, Nov'20) (Same concept different figures RTP Nov'19 & Nov '23,***

*PYP 5 Marks Nov'19, SM)*

**Answer 5**

Tax as per accounting profit 15,00,000X20%= ₹ 3,00,000
Tax as per Income-tax Profit 2,50,000X20% =₹ 50,000
Tax as per MAT 7,50,000X7.50%= ₹ 56,250
Tax expense= Current Tax +Deferred Tax
₹ 3,00,000 = ₹ 50,000+ Deferred tax
Therefore, Deferred Tax liability as on 31-03-2020
= ₹ 3,00,000 – ₹ 50,000 = ₹ 2,50,000
Amount of tax to be debited in Profit and Loss account for the year 31-03-2020
Current Tax + Deferred Tax liability + Excess of MAT over current tax
= ₹ 50,000 + ₹ 2,50,000 + ₹ 6,250 (56,250 – 50,000) = ₹ 3,06,250

## Question 6

**ABC Company limited had an investment in Venture Capital amounting ₹ 10 Crores. Venture capital in turn had invested in the below portfolio companies (New Start- ups) on behalf of ABC Limited:**

| Portfolio Companies | Amount of investment (₹ in Crores) |
|---|---|
| Oscar Limited | 2 |
| Zee Limited | 3 |
| Star Limited | 4 |
| Sony Limited | 1 |
| Total | 10 |

**During the FY 2019-2020, Venture Capital had sold their investment in Star Limited and realised an amount of ₹ 8 Crores on sale of shares of star Limited and entire proceeds of ₹ 8 Crores have been transferred by Venture Capital to ABC Company Limited.**

**The accounts manager has received the following additional information from venture capital on 31.03.2020:**

**(1) 8 Crores has been deducted from the cost of investment and carrying amount of investment as at year end is 2 Crores.**

**(2) Company had to pay a capital gain tax @ 20% on the net sale consideration of ₹ 4 Crores.**

**(3) Due to COVID-19, the remaining start - ups (i.e. Oscar Limited, Zee Limited, and Sony Limited) are not performing well and will soon wind up their operations. Venture capital is monitoring the situation and if required they will provide an impairment loss in June 2020 Quarter.**

**You need to suggest the accounts manager what should be the correct accounting treatment as per AS 22 "Accounting for Taxes on Income". (SM)**

**Answer 6**

As company had to pay capital gain tax @ 20% on the net sale consideration as per income tax laws, the company has to recognise a current tax liability of 0.8 Crores computed as under:

| Particulars | Amount (₹in Crores) |
|---|---|
| Sales Consideration | 8 |
| Cost of Investment | 4 |
| Net gain on Sale | 4 |
| Tax @ 20% | 0.8 |

As per AS 22, Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

| Particulars | Amount (₹in Crores) | Rationale |
|---|---|---|
| Taxable Income | 4 | As per income tax laws |
| AccountingIncome | Nil | As the same is deducted from the cost of investment |

| Timing Difference | 4 | |
|---|---|---|

As per AS 22, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realized.

Since in current scenario, due to Covid 19 the portfolio companies are not performing well, thus the company may not have sufficient future taxable income which will reverse deferred tax assets. Therefore, the company should not recognize DTA of ₹ 0.8 Crores and company should recognise only current tax liability of ₹ 0.8 Crores.

## Question 7

**The following particulars are stated in the Balance Sheet of Wiwitsu Limited as on 31st March, 2020:**

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

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

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

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

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

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

**Tax Rate to be taken at 40%.**

**You are required to show the impact of above items on Deferred Tax Assets and Deferred Tax Liability as on 31st March, 2021.** ***(PYP 5 Marks Jul'21)***



**Answer 7**

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

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

> **EXAM INSIGHTS:** The answers of majority examinees reflected lack of knowledge for the provisions of AS 22 "Accounting for Taxes on Income". Hence, they failed to show impact of the given items on Deferred Tax Assets and Deferred Tax Liability as on 31st March, 2021.

## Question 8

**The following particulars are stated in the Balance Sheet of Siddhi Limited as on 31st March,2022:**

| Particulars | (₹ In lakhs) |
|---|---|
| Deferred Tax Liabilities (Cr.) | 2.50 |
| Deferred Tax Assets (Dr.) | 1.35 |

**The following transactions were reported during the year 2022 -23:**

| | ₹ in lakhs |
|---|---|
| (i) Depreciation as per accounting records | 15.00 |
| (ii) Depreciation as per income tax records | 20.00 |
| (iii) Interest paid to NBFC accounted in books on accrual basis but paid on 30.06.2023 | 6.00 |
| (iv) Items disallowed for tax purposes in 2021-22 but allowed in 2022- 23 | 1.05 |
| (v) Donation to Private Trust | 40.00 |
| (vi) Tax rate | 15% |
| (vii) There were no additions to fixed assets during the year. | |

**You are required to calculate the Deferred Tax Asset and Deferred Tax Liability as on 31-03-2023 as per AS-22.** ***(PYP 5 Marks Nov'23)***

**Answer 8**

**Balances of Deferred tax assets and Deferred tax liability as on 31 st March, 2023**

| | ₹ (in lakhs) |
|---|---|
| Deferred tax liability (Cr.) (2.5 +.75) | 3.25 |
| Deferred tax asset (Dr.) (1.35 - 0.158*) | 1.192 |

**Working Note:**

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

| Sr. No. | Transactions | Nature of difference | Effect | Amount (₹) |
|---|---|---|---|---|
| (i), (ii) | Difference in depreciation | Responding timing difference | Creation of DTL | (20 - 15) x 15% = 0.75 |
| (iii) | Interest to financial institutions | No timing difference | Not applicable | Not applicable |
| (iv) | Disallowances, as per IT Act, of earlier years | Timing difference | Reversal of DTA | ₹ 1.05 lakh × 15% = ₹ 0.158* lakh |
| (v) | Donation to private trusts | Permanent difference | Not applicable | Not applicable |

*Alternatively, may be rounded off as ₹ 0.157 lakh or 0.1575.

> **EXAM INSIGHTS:** Most of the examinees could not compute the amount correct amounts of deferred tax liability and deferred tax asset as per the provisions of AS 22," Accounting for taxes on income". The question required separate calculations for deferred tax assets and deferred tax liability. However, some examinees combined the figures of deferred tax asset and deferred tax liability, resulting in a calculation of the answer on a net basis.

## Question 9

**Delta Ltd. is working on different projects those are likely to be completed within 3 years period. It recognizes revenue from these contracts on Percentage of Completion Method for Financial Statements for the years ending 2021, 2022 and 2023 for ₹ 34 Lakhs, ₹ 50 Lakhs and ₹ 65 Lakhs respectively. However, for Income Tax purpose, it has adopted the Completed Contract Method under which it has recognized revenue of ₹ 30 Lakhs, ₹ 52 Lakhs and ₹ 67 Lakhs for the years ending 2021, 2022 and 2023 respectively. Income Tax rate is 30%. Compute the amount of Deferred Tax Asset / Liability and Total Tax Expenses for the years ending 31st March 2021, 2022 and 2023.** ***(PYP 5 Marks Sep'24)***

**Answer 9**

**Calculation of Deferred Tax Asset/Liability in Delta Limited**

| Year | Accounting Income | Taxable Income | Timing Difference | Timing Difference (balance) | Deferred Tax | Deferred Tax Liability (balance) |
|---|---|---|---|---|---|---|
| 2021 | 34,00,000 | 30,00,000 | 4,00,000 | 4,00,000 | 1,20,000 | 1,20,000 |
| 2022 | 50,00,000 | 52,00,000 | (2,00,000) | 2,00,000 | (60,000) | 60,000 |
| 2023 | 65,00,000 | 67,00,000 | (2,00,000) | NIL | (60,000) | NIL |
| | 1,49,00,000 | 1,49,00,000 | | | | |

**Calculation of total tax**

| Year | Deferred Tax | Current tax expense | Total tax |
|---|---|---|---|
| 2021 | 1,20,000 | 9,00,000 (30,00,000 x 30%) | 10,20,000 |
| 2022 | (60,000) | 15,60,000 (52,00,000 x 30%) | 15,00,000 |
| 2023 | (60,000) | 20,10,000 (67,00,000 x 30%) | 19,50,000 |

**Note: It is assumed that the revenue and the taxable profit is the same.**



## Question 10

**(a) The following information is furnished in respect of Slate Ltd. for the year ending 31-3-2019:**

**(i) Depreciation as per books Rs. 2,80,000**
**Depreciation for tax purpose Rs. 1,90,000**
**The above depreciation does not include depreciation on new additions.**

**(ii) A new machinery purchased on 1.4.18 costing Rs. 1,20,000 on which 100% depreciation is allowed in the 1st year for tax purpose whereas Straight-line method is considered appropriate for accounting purpose with a life estimation of 4 years.**

**(iii) The company has made a profit of Rs. 6,40,000 before depreciation and taxes.**

**(iv) Corporate tax rate of 40%.**

**Prepare relevant extract of statement of Profit and Loss for the year ending 31-3-2019 and also show the effect of above items on deferred tax liability/asset as per AS 22.**

**(b) What are the disclosure requirements for deferred tax assets and deferred tax liabilities in the balance sheet as per AS 22?** ***(RTP May'21, PYP 5 Marks Nov'22)***

**Answer 10**

**(a) Statement of Profit and Loss for the year ended 31st March, 2019 (Extract)**

| | | | |
|---|---|---|---|
| | | | *Rs.* |
| Profit before depreciation and taxes | | | 6,40,000 |
| *Less*: Depreciation for accounting purposes (2,80,000+30,000) | | | (3,10,000) |
| Profit before taxes | (A) | | 3,30,000 |
| *Less*: Tax expense | (B) | | |
| Current tax (W.N.1) (3,30,000 x 40%) | | 1,32,000 | |
| Deferred tax (W.N.2) | | NIL | (1,32,000) |
| Profit after tax | (A-B) | | 1,98,000 |

**Working Notes:**

1. **Computation of taxable income**

| | Amount (Rs.) |
|---|---|
| Profit before depreciation and tax | 6,40,000 |
| *Less:* Depreciation for tax purpose (1,90,000 + 1,20,000) | (3,10,000) |
| Taxable income | 3,30,000 |
| Tax on taxable income @ 40% | 1,32,000 |

2. **Impact of various items in terms of deferred tax liability / deferred tax asset**

| Sr. No. | Transactions | Analysis | Nature of difference | Effect | Amount (Rs.) |
|---|---|---|---|---|---|
| (i) | Difference in depreciation | Generally, written down value method of depreciation is adopted under IT Act which leads to higher depreciation in earlier years of useful life of the asset in comparison to later years. | Responding timing difference | Reversal of DTL | (2,80,000 - 1,90,000) x 40% = (36,000) |
| (ii) | Depreciation on new machinery | Due to allowance of full amount as expenditure under IT Act, tax payable in the earlier years is less. | Timing difference | Creation of DTL | (1,20,000 – 30,000) x 40% = 36,000 |
| | Net impact | | | | NIL |

(b) The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts. Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities. The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

**EXAM INSIGHTS:** Majority of the examinees failed to calculate correct amount of accounting profit and profit as per income tax. They were also not able to mention the reversal of DTL or creation of DTL correctly, consequently failed to calculate the Net Effect of Deferred Tax.

## Question 11 LDR

**ABC Ltd. prepares its accounts annually on 31st March. On 1st April, 2022, it purchases a machine at a cost of ₹ 1,50,000. The machine has a useful life of three years and an expected scrap value of zero. Although it is eligible for a 100% first year depreciation allowance for tax purposes, the straight line method is considered appropriate for accounting purposes. ABC Ltd. has profits before depreciation and taxes of ₹ 2,00,000 each year and corporate tax rate is 40 percent each year.**

**The purchase of machine at a cost of ₹ 1,50,000 in 2022 gives rise to a tax saving of ₹ 60,000. The corporate tax rate has been assumed to be same in each of the three years. Calculate deferred tax and pass necessary journal entries.**

**What will be the amount of deferred tax, if the substantively enacted tax rates for 2022, 2023 and 2024 are 40%, 35% and 38% respectively.** ***(RTP Jan'25)***

**Answer 11**

If the cost of machine is spread over three years of its life for accounting purposes, the amount of the tax saving should also be spread over the same period as shown below:

**Statement of Profit and Loss**
**(for the three years ending 31st March, 2022, 2023, 2024)**

| | | (₹ in thousand) | | |
|---|---|---|---|---|
| | | **2022** | **2023** | **2024** |
| | Profit before depreciation and taxes | 200 | 200 | 200 |

| | | | | |
|---|---|---|---|---|
| *Less:* | Depreciation for accounting purposes | 50 | 50 | 50 |
| | Profit before taxes | 150 | 150 | 150 |
| *Less:* | Tax expense | | | |
| | Current tax: | | | |
| | 0.40 x (200 -150) | 20 | | |
| | 0.40 x 200 | | 80 | 80 |
| | Deferred tax: | | | |
| | Tax effect of timing differences originating during the year leading to DTL | | | |
| | 0.40 (150-50) | 40 | | |
| | Tax effect of timing differences reversing during the year | | | |
| | 0.40 (0-50) | - | (20) | (20) |
| | Tax expense | 60 | 60 | 60 |
| | Profit after tax | 90 | 90 | 90 |
| | Net timing differences | 100 | 50 | 0 |
| | Deferred tax liability balance | 40 | 20 | 0 |

In 2022, the amount of depreciation allowed for tax purposes exceeds the amount of depreciation charged for accounting purpose by₹ 1,00,000 and, therefore, taxable income is lower than the accounting income. This gives rise to a deferred tax liability of ₹ 40,000. In 2023 and 2024 accounting income is lower than taxable income because the amount of depreciation charged for accounting purposes exceeds the amount of depreciation allowed for tax purposes by ₹ 50,000 each year. Accordingly, deferred tax liability is reduced by ₹ 20,000 each in both the years. As may be seen, tax expense in based on the accounting income of each period.In 2022, the profit and loss account is debited and deferred tax liability account is credited with the amount of tax on the originating timing difference of ₹ 1,00,000 while in each of the following two years, deferred tax liability account is debited and profit and loss account is credited with the amount of tax on the reversing timing difference of ₹ 50,000.

The following Journal entries will be passed:

| | | | |
|---|---|---|---|
| **Year 2022** | | | |
| Profit and Loss A/c | Dr. | 20,000 | |
| To Current tax A/c<br>(Being the amount of taxes payable for the year 2022 provided for) | | | 20,000 |
| Profit and Loss A/c<br>To Deferred tax liability A/c<br>(Being the deferred tax liability created for originating timing difference of ₹ 1,00,000) | Dr. | 40,000 | 40,000 |
| **Year 2023** | | | |
| Profit and Loss A/c<br>To Current tax A/c<br>(Being the amount of taxes payable for the year 2023 provided for) | Dr. | 80,000 | 80,000 |
| Deferred tax liability A/c To Profit and Loss A/c<br>(Being the deferred tax liability adjusted for reversing timing difference of ₹ 50,000) | Dr. | 20,000 | 20,000 |
| **Year 2024** | | | |
| Profit and Loss A/c<br>To Current tax A/c<br>(Being the amount of taxes payable for the year 2024 provided for) | Dr. | 80,000 | 80,000 |
| Deferred tax liability A/c To Profit and Loss A/c<br>(Being the deferred tax liability adjusted for reversing timing difference of ₹ 50,000) | Dr. | 20,000 | 20,000 |

**Presentation:**

In the year 2022, the balance of deferred tax account i.e. ₹ 40,000 would be shown separately from the current tax payable for the year in terms of paragraph 30 of AS 22. In the year 2023, the balance of deferred tax liability account would be ₹ 20,000 and be shown separately from the current tax payable for the year as in year 2022. In year 2024, the balance of deferred tax liability account would be nil.

If the rate of tax changes, it would be necessary for the enterprises to adjust the amount of deferred tax liability carried forward by applying the tax rate that has been enacted or substantively enacted by the balance sheet date on accumulated timing differences at the end of the accounting year.

The amount of deferred tax liability would be computed as follows:

The deferred tax liability carried forward each year would appear in the balance sheet as under:

| | | |
|---|---|---|
| 31st March, 2022 | = 0.40 (1,00,000) | = ₹ 40,000 |
| 31st March, 2023 | = 0.35 (50,000) | = ₹ 17,500 |
| 31st March, 2024 | = 0.38 (Zero) | = ₹ Zero |

Accordingly, the amount debited (credited) to the profit and loss account (with corresponding credit or debit to deferred tax liability) for each year would be as under:

| | | |
|---|---|---|
| 31st March, 2022 | Debit | = ₹ 40,000 |
| 31st March, 2023 | (Credit) | = ₹ (22,500) |
| 31st March, 2024 | (Credit) | = ₹ (17,500) |

## Multiple Choice Questions (MCQs)

**1. As per AS 22 on 'Accounting for Taxes on Income', tax expense is *(SM)***

(a) Current tax + deferred tax charged to profit and loss account
(b) Current tax-deferred tax credited to profit and loss account
(c) Either (a) or (b)
(d) Deferred tax charged to profit and loss account

**Ans: (c)**

**2. G Ltd. has provided the following information:**
**Depreciation as per accounting records = ₹ 2,00,000**
**Depreciation as per tax records = ₹ 5,00,000**
**There is adequate evidence of future profit sufficiency.**
**How much deferred tax asset/liability should be recognized as transitionadjustment when the tax rate is 50%? *(SM)***

(a) Deferred Tax asset = ₹ 2,70,000.
(b) Deferred Tax asset = ₹ 1,35,000.
(c) Deferred Tax Liability = ₹ 2,70,000
(d) Deferred Tax Liability = ₹ 1,35,000.

**Ans: (d)**

**3. State which of the followings statements are correct:**
**(1) There are no pre-conditions required to recognize deferred tax liability,**
**(2) Deferred tax asset under all circumstances can only be created if and only if there is reasonable certainty that future taxable income will arise. *(SM)***

(a) Both are correct.
(b) Only (1) is correct.
(c) Only (2) is correct.
(d) None of the statements are correct.

**Ans: (a)**

**4. Which of the following statement are incorrect: *(SM)***

(a) Only timing differences result in creation of deferred tax.
(b) Permanent differences do not result in recognition of deferred tax.
(c) The tax rate used for measurement of deferred tax is substantively enacted tax rate.
(d) The entity has to recognize deferred tax liability/asset arising out of timing difference. There are no conditions which are required to evaluated for their recognition.

**Ans: (d)**

C

# CHAPTER 8.1: AS 7 "CONSTRUCTION CONTRACTS"

**CONCEPTS OF THIS CHAPTER**

- Scope of Construction Contract
- Recognition of Revenue/Expenses
- Recognition of Expected Losses
- Combining/Segmenting Contracts
- Contract Revenue
- Contract Costs
- Changes in Estimates

**LDR Questions**
**Q 13**

## QUICK REVIEW OF IMPORTANT CONCEPTS

| | | **Outcome can be measured reliably** |
|---|---|---|
| **Fixed price contract** | **Contractor agrees to a fixed contract price or fixed rate per unit of output, which in some cases is subject to cost escalation.** | • Total contract revenue can be measured reliably<br>• It is probable that the economic benefits associated with the contract will flow to the enterprise.<br>• Both contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably.<br>• Contract costs attributable to contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates. |
| **Cost plus contract** | **Contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee** | • It is probable that the economic benefits associated with the contract will flow to the enterprise.<br>• Contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably. |

**Final Outcome of the Contract**

| | |
|---|---|
| • **Can be estimated reliably** | Revenue and costs recognized as per percentage of completion method considering the stage of completion of contract at reporting date. |
| • **Can not be estimated Reliably** | Revenue should be recognized only to the extent of contract costs incurred, of which recovery is probable. |
| | Contract costs should be recognised as an expense in the period in which they are incurred. |

**Note:** Any expected loss (when contract cost > contract revenue) on the construction contract should be recognised as an expense immediately in both the situations.

**Contract Revenue-** Initial amount of revenue agreed in the contract.
Variations in contract work, claims and incentive payments if
(i) it is probable that they will result in revenue. (ii) they are capable of being reliably measured.

**Contract Costs**

- Costs that relate directly to the specific contract
- Costs that are attributable to contract activity in general and can be allocated to the contract.
- Such other costs as are specifically chargeable to the customer under the terms of the contract.

### Changes In Estimates

- Application of percentage of completion on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs.
- Effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate.
- The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is and in subsequent periods.

### Disclosures in Financial Statements

| | |
|---|---|
| • **General** | Amount of contract revenue recognised as revenue in the period<br>Methods used to determine the stage of completion of contracts in progress |
| • **Specific for contracts in progress** | Amount of advances received<br>Amount of retentions |

**An enterprise should present gross amount for contract work in the financial statements:**

| | |
|---|---|
| • Due from customers | – As an asset |
| • Due to customers | – As a liability |

**Question & Answers**

Question 1

**B Ltd. undertook a construction contract for ₹ 50 crores in April, 2020. The cost of construction was initially estimated at ₹ 35 crores. The contract is to be completed in 3 years. While executing the contract, the company estimated that the cost of completion of the contract would be ₹ 53 crores.**
**Can the company provide for the expected loss in the financial Statements for the year ended 31st March, 2021? Explain. *(RTP May'22)***

**Answer 1**

As per para 35 of AS 7 "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately. Therefore, the foreseeable loss of ₹ 3 crores (₹ 53 crores less ₹ 50 crores) should be recognized as an expense immediately in the year ended 31st March, 2021. The amount of loss is determined irrespective of

(i) Whether or not work has commenced on the contract;
(ii) Stage of completion of contract activity; or
(iii) The amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance provisions of AS 7.

Question 2

**(a) In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably only when certain conditions prescribed under AS 7 are satisfied. You are required to describe these conditions mentioned in the standard.**

**(b) Mr. 'X' as a contractor has just entered into a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional Rs. 2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily. Is X correct in his proposal? Discuss. *(RTP Nov'21)***

**Answer 2**

(a) In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:
   (i) total contract revenue can be measured reliably;
   (ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;
   (iii) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

(iv) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

(b) According to AS 7 (Revised) 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii) the amount of the incentive payment can be measured reliably. In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract.

## Question 3

**(a) Sky Limited belongs to Heavy Engineering Contractors specializing in construction of Flyovers. The company just entered into a contract with a local municipal corporation for building a flyover. No activity has started on this contract.**

**As per the terms of the contract, Sky Limited will receive an additional Rs. 50 lakhs if the construction of the flyover were to be finished within a period of two years from the commencement of the contract. The Accountant of the entity wants to recognize this revenue since in the past the company has been able to meet similar targets very easily. Give your opinion on this treatment.**

**(b) ABC Ltd., a construction contractor, undertakes the construction of commercial complex for XYZ Ltd. ABC Ltd. submitted separate proposals for each of 3 units of commercial complex. A single agreement is entered into between the two parties. The agreement lays down the value of each of the 3 units i .e. Rs. 50 lakh, Rs. 60 lakh and Rs. 75 lakh respectively. Agreement also lays down the completion time for each unit.**

**Comment, with reference to AS 7, whether ABC Ltd., should treat it as a single contract or three separate contracts. *(RTP May'21, May'23 & Nov'23)***

**Answer 3**

**(a)** According to AS 7 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when both the conditions are met:

(i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and

(ii) the amount of the incentive payment can be measured reliably.

In the given problem, the contract has not even begun and hence the contractor (Sky Limited) should not recognize any revenue of this contract. Therefore, the accountant's contention for recognizing Rs. 50 lakhs as revenue is not correct.

**(b)** As per AS 7 'Construction Contracts', when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

ABC Ltd. has submitted separate proposals for each of the 3 units of commercial complex. Also the revenue and completion time has been laid down for each unit separately which implies separate negotiation for them. Therefore, ABC Ltd. is required to treat construction of each unit as a separate construction contract as the above-mentioned conditions of AS 7 are fulfilled in the given case.

## Question 4

**Rose Constructions undertake to construct a bridge for the Government of Uttar Pradesh. The construction commenced during the financial year ending 31.03.2024 and is likely to be completed by the next financial year. The contract is for a fixed price of ₹ 12 crore with an escalation clause. You are given the following information for the year ended 31.03.2024:**

| | |
|---|---|
| Cost incurred upto 31.03.2024 | ₹ 4 crore |
| Cost estimated to complete the contract | ₹ 6 crore |

Escalation in cost was by 5%. Hence, the contract price is also increased by 5%.

You are required to ascertain the stage of completion and compute the amount of revenue and profit to be recognized for the year as per AS 7. *(RTP Jan'25)*

**Answer 4**

| | ₹ in crore |
|---|---|
| Cost of construction of bridge incurred upto 31.3.2024 | 4.00 |
| Add: Estimated future cost | 6.00 |
| Total estimated cost of construction | 10.00 |
| Contract Price (12 crore x 1.05) | 12.60 crore |

**Stage of completion**

Percentage of completion till date to total estimated cost of construction = (4/10) × 100 = 40 %

**Revenue and Profit to be recognized for the year ended 31st March, 2024 as per AS 7:**

Proportion of total contract value recognized as revenue

= Contract price x percentage of completion

= ₹ 12.60 crore x 40% = ₹ 5.04 crore

Profit for the year ended 31st March, 2024 = ₹ 5.04 crore – ₹ 4 crore = 1.04 crore.

## Question 5

Viv Tsu Ltd. signed on 01/04/21, a construction contract for Rs. 1,50,00,000. Following particulars are extracted in respect of contract, for the period ending 31/03/22:

- Materials issued Rs. 75,00,000
- Labour charges paid Rs. 36,00,000
- Hire charges of plant Rs. 10,00,000
- Other contract cost incurred Rs. 15,00,000
- Out of material issued, material lying unused at the end of period is Rs. 4,00,000
- Labour charges of Rs. 2,00,000 are still outstanding on 31.3.22.
- It is estimated that by spending further Rs. 33,50,000 (including material unused Rs. 4,00,000), the work can be completed in all respect.

  You are required to compute profit/loss to be taken to Profit & Loss Account and additional provision for foreseeable loss as per AS 7. *(MTP 5 Marks Apr'22, Mar'21, Oct'20 & Oct'23 SM)*

**Answer 5**

**Statement showing the amount of profit/loss to be taken to Profit and Loss Account and additional provision for the foreseeable loss as per AS 7**

| | Cost of Construction | Rs. | Rs. |
|---|---|---|---|
| | Material Issued | 75,00,000 | |
| Less: | Unused Material at the end of period | 4,00,000 | 71,00,000 |
| | Labour Charges paid | 36,00,000 | |
| Add: | Outstanding on 31.03.2022 | 2,00,000 | 38,00,000 |
| | Hire Charges of Plant | | 10,00,000 |
| | Other Contract cost incurred | | 15,00,000 |
| | Cost incurred up to 31.03.2022 | | 1,34,00,000 |
| Add: | Estimated future cost | | 33,50,000 |
| | Total Estimated cost of construction | | 1,67,50,000 |
| | Degree of completion (1,34,00,000/1,67,50,000 x 100) | | 80% |
| | Revenue recognized (80% of 1,50,00,000) | | 1,20,00,000 |
| | Total foreseeable loss (1,67,50,000 - 1,50,00,000) | | 17,50,000 |
| Less: | Loss for the current year (1,34,00,000 - 1,20,00,000) | | 14,00,000 |
| | Loss to be provided for | | 3,50,000 |

## Question 6

A contractor firm obtained a contract for construction of bridge. The following details are available in the records kept for the year ended March 31, 2021:

| | (Rs. In Crore) |
|---|---|
| Total Contract Price | 500 |

| | |
|---|---|
| Work Certified | 250 |
| Work not Certified | 80 |
| Estimated further Cost to Completion | 220 |
| Progress Payment Received | 200 |
| Payment to be Received | 70 |

You are required to calculate:

(i) The amount of revenue to be recognized.

(ii) The amount of profit or loss to be recognized.

(iii) The amount due from/ to customers.

Also present relevant disclosures as per AS-7 (Revised). (MTP 5 Marks Nov'21) (Same concept different figures (SM)

**Answer 6**

**(i) Proportion of total contract value recognized as revenue**

Percentage of completion of contract to total estimated cost of construction

= [(250 + 80) / (250 +80 + 220)]X 100 = 60%

Revenue to be recognized till date = 60% of Rs. 500 crore = Rs. 300 crore.

**(ii)**

| **Calculation of profit/ loss for the year ended 31st March, 2021** | | **(Rs. in crore)** |
|---|---|---|
| Total estimated cost of construction | | |
| Work certified | 250 | |
| Work not certified | 80 | |
| Estimated further cost to completion | 220 | 550 |
| *Less*: Total contract price | | (500) |
| Total foreseeable loss to be recognized as expense | | 50 |

According to AS 7 "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

**(iii) Amount due from / to customers = Contract costs incurred till date + Recognized profits – Recognized losses – (Progress payments received + Progress payments to be received)**

= Rs. [(250 + 80) + Nil – 50 – (200 + 70)] crore = Rs. [330 – 50 – 270] crore

Amount due from customers (shown as an asset) = Rs. 10 crore.

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

| | Rs. in crores |
|---|---|
| Contract revenue till 31st March, 2021 | 300 |
| Contract expenses till 31st March, 2021 | 330 |
| Recognized losses for the year 31st March, 2021 | 50 |
| Progress billings Rs. (200+ 70) | 270 |
| Progress (billed but not received from contractee) | 70 |
| Gross amount due from customers | 10 |

## Question 7

Constructions Limited is engaged in the business of constructing Flyovers and Railway over bridges. It obtained a contract from Railway Authorities to construct a railway over bridge for ₹ 400 crores. The construction of the railway over bridge is expected to be completed in 4 years.

At the outset of the contract, it was estimated that the total costs to be incurred will be ₹ 370 crores but by the end of year 1, this estimate stands revised to ₹ 375 crores.

During year 3, the Construction Limited has requested for a variation in the contract which is approved by Railway Authorities and accordingly the total contract value will increase by ₹ 10 crores and costs will increase by ₹ 7 crores.

The Constructions Limited decided to measure the stage of completion on the basis of the proportion of contract costs incurred to the total estimated contract costs. Contract costs incurred at the end of each year is:

Year 1 ₹ 98.8 crores

Year 2 ₹ 202.4 crores

Year 3 ₹ 310 crores (including unused material of 3 crores)
Year 4 ₹ 382 crores

You are required to:

(1) Calculate stage of completion of contract for each year

(2) Profit to be recognised for each year. *(PYP 7 Marks May'24)*

**Answer 7**

**Stage of completion = Costs incurred to date / Total estimatedcosts**

Year 1: 98.8 crore / 375 crore = 26.35%

Year 2: 202.4 crore / 375 crore = 53.97%

Year 3: (310 crore – 3 crore) / (375+7) crore = 80.37%

Year 4: 382 crore / 382 crore = 100%

**Profit to be recognized each year has been calculated as follows:**

| | **Year 1** | **Year 2** | **Year 3** | **Year 4** |
|---|---|---|---|---|
| Contract Revenue (1) | 105.40 crore | 110.48 crore | 113.64 crore | 80.48 crore |
| | (400 crore x 26.35%) | (400 crore x 53.97% - 105.40 crore) | (410 crore x 80.37% - 105.40 crore -110.48 crore) | (410 crore x 100% - 105.40 crore - 110.48 crore - 113.64 crore) |
| Contract Cost (2) | 98.8 crore | 103.60 crore | 104.60 crore | 75 crores |
| | | 202.40 - 98.80 crore) | (307 crore - 98.8 crore- 103.60 crore) | (382 crore - 98.8 crore- 103.6 crore – 104.6 crore) |
| ContractProfit (1) – (2) | 6.60 crore | 6.88 crore | 9.04 crore | 5.48 crore |

## Question 8

PRZ & Sons Ltd. are Heavy Engineering contractors specializing in construction of dams. From the records of the company, the following data is available pertaining to year ended 31st March, 2021:

| | (Rs. crore) |
|---|---|
| Total Contract Price | 2,400 |
| Work Certified | 1,250 |
| Work pending certification | 250 |
| Estimated further cost to completion | 1,750 |
| Stage wise payments received | 1,100 |
| Progress payments in pipe line | 300 |

Using the given data and applying the relevant Accounting Standard you are required to:

(i) Compute the amount of profit/loss for the year ended 31st March, 2021.

(ii) Arrive at the contract work in progress as at the end of financial year 2020-21.

(iii) Determine the amount of revenue to be recognized out of the total contract value.

*(iv)* Work out the amount due from/to customers as at year end. *(MTP 5 Marks Oct'21 & Apr'23)*
*(Same concept different figures MTP 5 Marks Mar'22, PYP 5 Marks May'18 & May'23)*

**Answer 8**

| (i) | **Calculation of profit/ loss for the year ended 31st March, 2021** | (Rs. in crores) |
|---|---|---|
| | Total estimated cost of construction (1,250 + 250 + 1,750) | 3,250 |
| | *Less*: Total contract price | (2,400) |
| | Total foreseeable loss to be recognized as expense | 850 |

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

| (ii) | **Contract work-in-progress i.e. cost incurred to date** | (Rs. in crores) |
|---|---|---|
| | Work certified | 1,250 |

| | | | |
|---|---|---|---|
| | Work not certified | | 250 |
| | | | 1,500 |

**(iii) Proportion of total contract value recognized as revenue**

Percentage of completion of contract to total estimated cost of construction

= (1,500 / 3,250) X 100 = 46.15%

Revenue to be recognized till date = 46.15% of Rs. 2,400 crores = Rs. 1,107.60 crores.

**(iv) Amount due from / to customers** = Contract costs + Recognized profits – Recognized losses – (Progress payments received + Progress payments to be received)

= Rs. [1,500 + Nil – 850 – (1100 + 300)] crores

= Rs. [1,500 – 850 – 1,400] crores

Amount due to customers (shown as liability) = Rs. 750 crores.

**EXAM INSIGHTS:** Few examinees could not compute profit / loss for the year, contract work in progress and amount due from/ to customers at the year end, revenue to be recognized out of the total contract in line with AS 7 "Construction Contracts".

## Question 9

**The following data is provided for M/s. Raj Construction Co.**

**(i) Contract Price - ₹ 85 lakhs**

**(ii) Materials issued - ₹ 21 Lakhs out of which Materials costing ₹ 4 Lakhs is still lying unused.at the end of the period.**

**(iii) Labour Expenses for workers engaged at site - ₹ 16 Lakhs (out of which ₹ 1 Lakh is still unpaid)**

**(iv) Specific Contract Costs = ₹ 5 Lakhs**

**(v) Sub-Contract Costs for work executed - ₹ 7 Lakhs, Advances paid to Sub-Contractors - ₹ 4 Lakhs**

**(vi) Further Cost estimated to be incurred to complete the contract - ₹ 35 Lakhs**

**You are required to compute the Percentage of Completion, the Contract Revenue and Cost to be recognized as per AS-7.** ***(RTP May'24) (Same Concept different figure MTP 5 Marks Oct'22, PYP 5 Marks Jul'21)***

**Answer 9**

**Computation of contract cost**

| | **₹ Lakh** | **₹ Lakh** |
|---|---|---|
| Material cost incurred on the contract (net of closing stock) | 21-4 | 17 |
| Add: Labour cost incurred on the contract (including outstanding amount) | | 16 |
| Specified contract cost | given | 5 |
| Sub-contract cost(advances should not be considered) | | 7 |
| Cost incurred (till date) | | 45 |
| Add: further cost to be incurred | | 35 |
| Total contract cost | | 80 |

**Percentage of completion** = Cost incurred till date/Estimated total cost

= ₹ 45,00,000/₹ 80,00,000 = 56.25%

**Contract revenue and costs to be recognized**

Contract revenue (₹ 85,00,000x56.25%) = ₹ 47,81,250

Contract costs = ₹ 45,00,000

**EXAM INSIGHTS:** July 21: Most of the examinees failed to compute the percentage of completion, contract revenue and contract cost to be recognized in accordance with the provisions of AS 7 "Construction Contracts".

## Question 10

**On 1st December, 2021, GR Construction Co. Ltd. undertook a contract to construct a building for ₹ 45 lakhs. On 31st March, 2022, the company found that it had already spent ₹ 32.50 lakhs on the construction. Additional cost of completion is estimated at ₹ 15.10 lakhs. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2022 as per provisions of AS-7?** ***(RTP May'23 & Nov'23, PYP 5 Marks May'19, New SM) (Same concepts different figures MTP 5 Marks Sep'22, RTP Nov'19, Nov'22)***

**Answer 10**

| | ₹ in lakhs |
|---|---|
| Cost of construction incurred till date | 32.50 |
| Add: Estimated future cost | 15.10 |
| Total estimated cost of construction | 47.60 |

Percentage of completion till date to total estimated cost of construction
= (32.50/47.60) X 100 = 68.28%

Proportion of total contract value recognized as revenue for the year ended 31st March, 2022 per AS 7 (Revised)
= Contract price x percentage of completion
= ₹ 45 lakh x 68.28% = ₹ 30.73 lakhs.

| | (₹ in lakhs) |
|---|---|
| Total cost of construction | 47.60 |
| Less: Total contract price | (45.00) |
| Total foreseeable loss to be recognized as expense | 2.60 |

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

**EXAM INSIGHTS:** May 19: Majority of the examinees were not able to give the required answer in line with AS 9 'Revenue recognition'. Few examinees were able to calculate the correct amount to be recognized as revenue but failed to substantiate it with valid reasons.

## Question 11

**Mehta ltd. has undertaken bridge construction contract wherein, bridge will be constructed in 3 years. The details of the contracts are as follows:**

**(i) Initial contract revenue ₹ 900 crore**

**(ii) Initial contract cost ₹ 800 crore**

| | Years | | |
|---|---|---|---|
| | I | II | III |
| | ₹ in crore | ₹ in crore | ₹ in crore |
| Estimated contract cost | 805 | | |
| Increase in contract revenue | - | 20 | |
| Estimated additional increase cost | - | 15 | |
| Contract cost incurred up to | 161 | 584 | 820 |

**At the end of year II, cost incurred includes ₹ 10 crore, for material stored at the sites to be used in year III to complete the project. State the amount of revenue, expenses and profit to be recognized in the Statement of Profit and Loss in these three years.** ***(RTP Sep'24)***

**Answer 11**

**Statement showing analysis of the contract details**

| | | | | **(₹ in crore)** |
|---|---|---|---|---|
| | | Year I | Year II | Year III |
| (a) | Initial revenue agreed | 900 | 900 | 900 |
| (b) | Increase in contract revenue | - | 20 | 20 |
| (c) | Total Contract Value | 900 | 920 | 920 |
| (d) | Contract cost incurred upto the date of reporting | 161 | 574 | 820 |
| | | | (excluding ₹ 10* crore of material stored) | |
| (e) | Estimated cost to complete | 644 | 246 | - |
| (f) | Total estimated contract | 805 | 820(805+15) | 820 |
| (g) | Stage of Completion | 20% | 70% | 100% |

| | [(d/f) x 100)] | (161/805 x 100) | (574/820 x 100) | (820/820 x 100) |
|---|---|---|---|---|

* Note: 10 crore, for material stored at the sites to be used in its 1st year. i.e. in IInd year it is already included so it will be deducted in II year only.

**Statement showing amount of revenue, expenses and profit to be recognized in the Statement of Profit and Loss in three years**

| | Upto reporting date | Recognised in the prior year | Recognized in the current year |
|---|---|---|---|
| **Year I** | | | |
| Revenue (900 x 20/100) | 180 | - | 180 |
| Expenses | 161 | - | 161 |
| Profit | 19 | - | 19 |
| **Year II** | | | |
| Revenue (920 x 70/100) | 644 | 180 | 464 |
| Expenses (820 x 70/100) | 574 | 161 | 413 |
| Profit | 70 | 19 | 51 |
| **Year III** | | | |
| Revenue | 920 | 644 | 276 |
| Expenses | 820 | 574 | 246 |
| Profit | 100 | 70 | 30 |

## Question 12

**Rajendra undertook a contract ₹ 20,00,000 on an arrangement that 80% of the value of work done, as certified by the architect of the contractee should be paid immediately and that the remaining 20% be retained until the Contract was completed.**

**In Year 1, the amounts expended were ₹ 8,60,000, the work was certified for ₹ 8,00,000 and 80% of this was paid as agreed. It was estimated that future expenditure to complete the Contract would be ₹ 10,00,000.**

**In Year 2, the amounts expended were ₹ 4,75,000. Three-fourth of the work under contract was certified as done by December 31st and 80% of this was received accordingly. It was estimated that future expenditure to complete the Contract would be ₹ 4,00,000.**

**In Year 3, the amounts expended were ₹ 3,10,000 and on June 30th, the whole Contract was completed. Show how Contract revenue would be recognized in the P & L A/c of Mr. Rajendra each year.**

***(PYP 5 Marks, Nov'20) (MTP 5 Marks Sep'23)***

**Answer 12**

**(a) Year 1**

| | ₹ |
|---|---|
| Actual expenditure | 8,60,000 |
| Future estimated expenditure | 10,00,000 |
| Total Expenditure | 18,60,000 |

% of work completed = $\frac{8,60,000}{18,60,000} \times 100$ = 46.24% (Rounded off)

Revenue to be recognized = 20,00,000 x 46.24%
= (9,24,800)

**Year 2**

Actual expenditure 4,75,000
Future Expenditure 4,00,000
Expenditure incurred in year 1 8,60,000
17,35,000

% of work completed = $\frac{4,75,000+8,60,000}{17,35,000}$ = 76.95% (Rounded off)

Revenue to be recognized (cumulative) = 20,00,000 ×76.95%
= 15,39,000

Less: revenue recognized in Year 1 = (9,24,800)

Revenue to be recognized in Year 1 = Rs. 6,14,200

**Year 3**

Whole contract got completed therefore total contract value less revenue recognized up to year 2 will be amount of revenue to be recognized in year 3 i.e. 20,00,000 – 15,39,000 (9,24,800 + 6,14,200) = ₹ 4,61,000.

Note: Calendar year has been considered as accounting year.

## Question 13 LDR

**Grace Ltd., a firm of contractors provided the following information in respect of a contract for the year ended on 31st March,2022:**

| Particulars | (₹ in '000) |
|---|---|
| Fixed Price Contract with an escalation clause Work Certified | 35,000 |
| Work not Certified (includes ₹ 26,25,000 for materials issued, out of which material lying unused at the end of the period is ₹ 1,40,000) | 17,500 |
| Estimated further cost to completion | 3,815 |
| Progress Payment Received Payment to be Received | 17,325 |
| Escalation in cost is by 8% and accordingly the contract price is increased by 8% | 14,000<br>4,900 |

**From the above information, you are required to:**

I. **Compute the contract revenue to be recognized.**

II. **Calculate Profit /Loss for the year ended 31st March,2022 and additional provision for loss to be made, if any, for the year ended 31st March,2022.** ***(PYP 5 Marks May'22)***

**Answer 13**

Calculation of total estimated cost of construction

| | | ₹ in thousand |
|---|---|---|
| Cost of Contract incurred till date | | |
| Work certified | 17,500 | |
| Work not certified (3,815 thousand – 140 thousand) | 3,675 | 21,175 |
| Add: Estimated future cost | | 17,325 |
| Total estimated cost of construction | | 38,500 |
| Contract Price (35,000 thousand x 1.08) | | 37,800 |

**Stage of completion**

Percentage of completion till date to total estimated cost of construction = [Cost of work completed till date / total estimated cost of the contract] x 100

= [₹ 21,175 thousand / ₹ 38,500 thousand] x 100= 55%

**Revenue to be recognized for the year ended 31stMarch, 2022**

Proportion of total contract value recognized as revenue = Contract price x percentage of completion = ₹ 37,800 thousand x 55% = ₹ 20,790 thousand

**Loss to be recognized for the year ended 31st March, 2022**

Loss for the year ended 31stMarch, 2022 = Cost incurred till date – Revenue to be recognized for the year ended 31st March, 2022 = ₹ 21,175 thousand – ₹ 20,790 thousand = ₹ 385 thousand

**Provision for loss to be made at the end of 31stMarch, 2022**

| | | ₹<br>in thousand |
|---|---|---|
| Total estimated loss on the contract | | |
| Total estimated cost of the contract | 38,500 | |
| Less: Total revised contract price | (37,800) | 700 |
| Less: Loss recognized for the year ended 31st March, 2022 | | (385) |
| Provision for loss to be made at the end of 31stMarch, 2022 | | 315 |

**EXAM INSIGHTS**: Some of the examinees were able to compute the contract revenue, profit/loss to be recognized for the year ended 31st March,2022 but erred in calculation of additional provision for loss to be made for the year ended 31st March,2022 as per AS 7 "Construction contracts".

## Multiple Choice Questions (MCQs)

The below information relates to Questions 1 – 3: *(SM)*

XY Ltd. agrees to construct a building on behalf of its client GH Ltd. on 1st April 20X1. The expected completion time is 3 years. XY Ltd. incurred a cost of ₹ 30 lakh up to 31st March 20X2. It is expected that additional costs of ₹ 90 lakh. Total contract value is ₹ 112 lakh. As at 31st March 20X2, XY Ltd. has billed GH Ltd. for ₹ 42 lakh as per the agreement. Assume that the work is completed to the extent of 75% by the end of Year 2.

1. Revenue to be recognized by XY Ltd. for the year ended 31st March 20X2 is
   (a) ₹ 28 lakh (b) ₹ 42 lakh
   (c) ₹ 30 lakh (d) ₹ 32 lakh

**Ans: (a)**

2. Total expense to be recognised in Year 1 is
   (a) ₹ 30 lakh (b) ₹ 120 lakh
   (c) ₹ 38 lakh (d) ₹ 36 lakh

**Ans: (d)**

3. Revenue to be recognised for year 2 is
   (a) ₹ 84 lakh (b) ₹ 42 lakh
   (c) ₹ 56 lakh (d) ₹ 28 lakh

**Ans: (c)**

Below information relates to Questions 4 – 5 *(SM)*

M/s AV has presented the information for Contract No. XY123:

| | |
|---|---|
| Total contract value | ₹ 370 lakh |
| Certified work completed | ₹ 320 lakh |
| Costs incurred to date | ₹ 360 lakh |
| Progress Payments received | ₹ 300 lakh |

Expected future costs to be incurred ₹ 50 lakh. The revenue to be recognised based on the certified work completed.

4. Revenue to be recognized by M/s AV is
   (a) ₹ 320 lakh
   (b) ₹ 370 lakh
   (c) ₹ 360 lakh
   (d) ₹ 400 lakh

**Ans: (a)**

5. Total expense to be recognized by M/s AV is
   (a) ₹ 380 lakh
   (b) ₹ 400 lakh
   (c) ₹ 320 lakh
   (d) ₹ 360 lakh

**Ans: (d)**

6. LP Contractors undertakes a fixed price contract of ₹ 200 lakh. Transactions related to the contract include:
   Material purchased: ₹ 80 lakh
   Unused material: ₹ 30 lakh
   Labour charges: ₹ 60 lakh
   Machine used for 3 years for the contract. Original cost of the machine is ₹ 100lakh. Expected useful life is 15 years. Estimated future costs to be incurred to complete the contract: ₹ 80 lakh.
   Loss on contract to be recognised is: *(SM)*
   (a) ₹ 40 lakh
   (b) ₹ 10 lakh
   (c) ₹ 90 lakh
   (d) ₹ 50 lakh

**Ans: (b)**

B

# CHAPTER 8.2: AS 9 "REVENUE RECOGNITION"

**CONCEPTS OF THIS CHAPTER**

- Sale of Goods
- Rendering of Services
- Effect of Uncertainties
- Required Disclosures
- Use of Resources Yielding Interest, Royalties, Dividends

LDR

LDR Questions
Q 15

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Revenue:** Is the gross inflow of cash, receivables or other consideration arising from the following:

- Sale of goods
- Rendering of Services
- Use by others of enterprise resources yielding interest, royalties and dividends

### AS 9 does not deal with reveue arising from

- Construction contracts
- Hire-purchase, lease agreements
- Government grants and other similar subsidies
- Insurance contracts of insurance companies

### Items not included within the definition of "revenue"

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

### Sale of Goods

**In sale of goods, performance should be regarded as being achieved when:**

- Seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred.
- No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

### Rendering of Services

**Methods of recognition of Revenue**

| | |
|---|---|
| ♦ Proportionate completion method | • Recognition of revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract.<br>• Performance consists of the execution of more than one act.<br>• Revenue is recognised proportionately by reference to the performance of each act. |
| ♦ Completed service contract method | • Recognition of revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed.<br>• Services become chargeable.<br>• Performance consists of the execution of a single act. |

### Recognition of Revenue when enterprise resources are used by others

- Interest - ***Time basis***
- Royalties - ***Accrual basis depending upon the terms of agreement***
- Dividends - ***When right to receive the payment is established***

### Effect of Uncertainties on Revenue Recognition

When ultimate collectability cannot be reasonably assessed at the time of raising a claim, revenue recognition is postponed to reflect the uncertainty. If uncertainty arises after the sale or service, it's more appropriate to create a separate provision rather than adjusting the original revenue amount.

### Disclosures

In addition to the disclosures required by AS 1 "Disclosure of Accounting Policies", an enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

## Question & Answers

### Question 1

**Y Ltd., used certain resources of X Ltd. In return X Ltd. received ₹ 10 lakhs and 15 lakhs as interest and royalties respective from Y Ltd. during the year 2022-23. You are required to state whether and on what basis these revenues can be recognized by X Ltd.** ***(MTP 4 Marks Mar'24, New SM)***

**Answer 1**

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

(i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable. Therefore X Ltd. should recognize interest revenue of ₹ 10 Lakhs.

(ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement. X Ltd. therefore should recognize royalty revenue of ₹ 15 Lakhs.



### Question 2

**When will the revenue be recognized in the case of inter divisional transfers?** ***(RTP Sep'24)***

**Answer 2**

The Accounting Standard Board of ICAI has come up with an announcement in the earlier years wherein it clarified that the inter- divisional transfers/sales are not revenue as per AS 9 "Revenue Recognition". According to it, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Therefore, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers. Hence, no revenue is recognized in the case of inter-divisional transfers.

### Question 3

**An infrastructure company has constructed a mall and entered into agreement with tenants towards license fee (monthly rental) and variable license fee, a percentage on the turnover of the tenant (on an annual basis). Chief Financial Officer of the company wants to account/recognize license fee as income for 12 months during current year and variable license fee as income during next year, since invoice is raised in the subsequent year. Comment whether the treatment desired by the CFO is correct or not.** ***(RTP May'22)***

**Answer 3**

AS 9 on Revenue Recognition, is mainly concerned with the timing of recognition of revenue in the Statement of Profit and Loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. However, when uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition. Further, as per accrual concept, revenue should be recognized as and when it is accrued i.e. recorded in the financial statements of the periods to which they relate. In the present case, monthly rental towards license fee and variable license fee as a percentage on the turnover of the tenant (though on annual basis) is the income related to common financial year.

Therefore, recognizing the fee as revenue cannot be deferred simply because the invoice is raised in subsequent period. Hence it should be recognized in the financial year of accrual. Therefore, the contention of the Chief Financial Officer is not in accordance with AS 9.

## Question 4

**When revenue will be recognized in the following situation:**

(i) **Where the purchaser makes a series of installment payments to the seller and the seller deliver the goods only when the final payment is received.**

(ii) **Where seller concurrently agrees to repurchase the same goods at a later date.**

(iii) **Where goods are sold to distributors, dealers or others for resale.**

(iv) **Commissions on service rendered as agent on insurance business.** ***(RTP Nov'22)***

### Answer 4

i. Revenue from sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received, should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

ii. For sale where seller concurrently agrees to repurchase the same goods at a later date, such transactions are in substance a financing agreement. In such a situation, the resulting cash inflow should not be recognised as revenue.

iii. Revenue from sales of goods to distributors, dealers or others for resale can generally be recognised if significant risks of ownership have passed. However, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

iv. Commissions on service rendered as agent on insurance business should be recognised as revenue when the service is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.



## Question 5

**PQR Ltd., sells agriculture products to dealers. One of the conditions of sale is that interest is at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2021-22 the company wants to recognize the entire interest receivable. Do you agree?** ***(RTP May'23, SM)***

### Answer 5

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

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

## Question 6

**New Era Publications publishes a monthly magazine on 15th of every month. It sells advertising space in the magazine to advertisers on the terms of 80% sale value payable in advance and the balance within 30 days of the release of the publication. The sale of space for the March 2020 issue was made in February 2020. The magazine was published on its scheduled date. It received Rs. 2,40,000 on 10.3.2020 and Rs. 60,000 on 10.4.2020 for the March, 2020 issue.**

**Discuss in the context of AS 9 the amount of revenue to be recognized and the treatment of the amount received from advertisers for the year ending 31.3.2020. What will be the treatment if the publication is**

**delayed till 2.4.2020? *(MTP 5 Marks Oct'20, Mar 22 & Oct'23)***

**Answer 6**

As per AS 9 'Revenue Recognition', in a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method as the service is performed, whichever relates the revenue to the work accomplished. In the given case, income accrues when the related advertisement appears before public. The advertisement service would be considered as performed on the day the advertisement is published and hence revenue is recognized on that date. In this case, 15.03.20 20 is the date of publication of the magazine. Hence, Rs. 3,00,000 (Rs. 2,40,000 + Rs. 60,000) is recognized as income in March, 2020. The terms of payment are not relevant for considering the date on which revenue is to be recognized. Since, the revenue of Rs. 3,00,000 will be recognized in the March, 2020, Rs. 60,000 will be treated as amount due from advertisers as on 31.03.20 20 and Rs. 2,40,000 will be treated as payment received against the sale. However, if the publication is delayed till 02.04.2020 revenue recognition will also be delayed till the advertisements get published in the magazine. In that case revenue of Rs. 3,00,000 will be recognized in the year ended 31.03.2020 after the magazine is published on 02.04.2020. The amount received from sale of advertising space on 10.03.2020 of Rs. 2,40,000 will be considered as an advance from advertisers as on 31.03.2020.

## Question 7

**Indicate in each case whether revenue can be recognized and when it will be recognized as per AS -9.**

**(1) Trade discount and volume rebate received.**

**(2) Whether goods are sold to distributor or others for resale.**

**(3) Whether seller concurrently agrees to repurchase the same goods at a late date.**

**(4) Insurance agency commission for rendering services.**

**(5) On 11-3-2019 cloths worth Rs. 50,000 were sold to X mart, but due to refurbishing of their showroom being underway, on their request cloths were delivered on 12-04-2019.**

***(PYP 5 Marks Nov'19, RTP May'22)***

**Answer 7**

(1) Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

(2) When goods are sold to distributor or others, revenue from such sales can generally be recognized if significant risks of ownership have passed; however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

(3) For transactions, where seller concurrently agrees to repurchase the same goods at a later date that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognized as revenue.

(4) Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

(5) On 11.03.2019, if X mart takes title and accepts billing for the goods then it is implied that the sale is complete and all risk and reward on ownership has been transferred to the buyers.

Revenue should be recognized for year ended 31st March, 2019 notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made and items were ready for delivery to the buyer at the time.

**EXAM INSIGHTS:** Majority of the examinees were not able to explain whether revenue should be recognized and when it should be recognized as per AS 9 "Revenue Recognition".

## Question 8

**Indicate in each case whether revenue can be recognized and when it will be recognized as per AS-9.**

**(i) Delivery is delayed at buyer's request but buyer takes title and accepts billing.**

**(ii) Instalment Sales.**

**(iii) Trade discounts and volume rebates.**

(iv) **Insurance agency commission for rendering services.**
(v) **Advertising commission.** ***(PYP 5 Marks Nov'22)***

**Answer 8**

(i) **Delivery is delayed at buyer's request and buyer takes title and accepts billing** : Revenue should be recognized notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognized rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

(ii) **Instalment sales**: When the consideration is receivable in instalments, revenue attributable to the sales price exclusive of interest should be recognized at the date of sale. The interest element should be recognized as revenue, proportionately to the unpaid balance due to the seller.

(iii) **Trade discounts and volume rebates**: Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

(iv) **Insurance agency commissions for rendering services**: Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

(v) **Advertising commission**: Revenue should be recognized when the service is completed. For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognized when the project is completed.

> **EXAM INSIGHTS:** Majority of the examinees shows lack of knowledge regarding provisions of AS 9. They failed to explain whether revenue should be recognized and when it should be recognized in line with AS 9 "Revenue Recognition".

### Question 9

**Old Era Publication Publishes a popular monthly magazine on 15th of every month. The publication sells the advertising space on terms of 90% payable in advance and the balance 10% payable within 30 days of release of the publication. The space for March 2023 issue of the magazine was sold in the month of February, 2023. The magazine was published as per schedule on 15th of the month. The amount of ₹ 2,70,000 has been received up to 31st March, 2023 and ₹ 30,000 was received on 10th April, 2023 for advertisement published in the March issue of the publication.**

**Please advise the accountant the amount of revenue to be recognized in the context of the provisions of AS 9 'Revenue Recognition' during the year ending on 31 st March, 2023.** ***(MTP 5 Marks Apr'23, Oct'21)***

**Answer 9**

**Definition:** As per AS 9 'Revenue Recognition', in a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished.

**Analysis of given case:** In the given case, income accrues when the related advertisement appears before public. The advertisement service would be considered as performed on the day the advertisement is appeared for public and hence revenue is recognized on that date. In this case, it is 15.03.2023, the date of publication of the magazine.

**Accounting treatment for given situation:** Hence, ₹ 3,00,000 (₹ 2,70,000 + ₹ 30,000) is recognized as income in March, 2023. The terms of payment are not relevant for considering the date on which revenue is to be recognized. ₹ 30,000 is treated as amount due from advertisers as on 31.03.2023 and ₹ 2,70,000 will be treated as payment received against the sale.

### Question 10

**Mithya Ltd. entered into agreement with Satya Ltd. for sale of goods costing ₹ 8 lakh at a profit of 20% on cost. The sale transaction took place on 1st February, 2024. On the same day, Satya Ltd. entered into another agreement with Mithya Ltd. to resell the same goods at ₹ 10.80 lakh on 1st August, 2024. State the treatment of this transaction in the financial statements of Mithya Ltd. as on 31.03.2024. The pre- determined re-selling**

price covers the holding cost of Satya Ltd. Give the Journal Entries as on 31.03.2024 in the books of Mithya Ltd. *(RTP Jan'25)*

**Answer 10**

**In the given case, Mithya Ltd. concurrently agreed to repurchase the same goods** from Satya Ltd. on 1st February, 2024. Also the re-selling price is pre-determined and covers purchasing and holding costs of Satya Ltd. Hence, the transaction between Mithya Ltd. and Satya Ltd. on 1st February, 2024 should be accounted for as financing rather than sale. The resulting cash flow of ₹ 9.60 lakh received by Mithya Ltd., cannot be considered as revenue as per AS 9 "Revenue Recognition".

**Journal Entries in the books of Mithya Ltd.**

| | | | | |
|---|---|---|---|---|
| | | | | **₹ in lakh** |
| 1.2.2024 | Bank Account | Dr. | 9.60 | |
| | To Advance from Satya Ltd*. (Being advance received from Satya Ltd. amounting [₹ 8 lakh + 20% of ₹ 8 lakh = 9.60 lakh] under sale and re-purchase agreement) | | | 9.60 |
| 31.3.2024 | Financing Charges Account<br>To Satya Ltd.<br>(Financing charges for 2 months [(10.80 – 9.60) x 2/6] | Dr. | 0.40 | <br>0.40 |
| 31.3.2024 | Profit and Loss Account | Dr. | 0.40 | |
| | To Financing Charges Account (Being amount of finance charges transferred to P& L Account) | | | 0.40 |

## Question 11

**(a) How will you recognize revenue in the following cases:**

1. **Installation Fees;**
2. **Advertising and insurance agency commissions;**
3. **Subscriptions for publications.**

**(b) Viv Tsu Ltd., has been successful jewellers for the past 100 years and sales are against cash only (returns are negligible). The company also diversified into apparels. A young senior executive was put in charge of Apparels business and sales increased 5 times. One of the conditions for sales is that dealers can return the unsold stocks within one month of the end of season. Sales return for the year was 25% of sales. Suggest a suitable Revenue Recognition Policy, with reference to AS 9.** *(RTP Nov'21)*

**Answer 11**

**(a)** **Installation Fees**: In cases where installation fees are other than incidental to the sale of a product, they should be recognized as revenue only when the equipment is installed and accepted by the customer.

**Advertising and insurance agency commissions**: Revenue should be recognized when the service is completed. For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognized when the project is completed. Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

**Subscription for publications**: Revenue received or billed should be deferred and recognized either on a straight-line basis over time or, where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

**(b)** As per AS 9 "Revenue recognition", revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

**Effect of Uncertainty**- In the case of the jewellery business the company is selling for cash and returns are negligible. Hence, revenue can be recognized on sales. On the other hand, in Apparels Industry, the dealers have a right to return the unsold goods within one month of the end of the season. In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 25% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately for both Jewellery and Apparels business.

## Question 12

**Tonk Tanners is engaged in manufacturing of leather shoes. They provide you the following information for the year ended 31st March, 2022:**

**(i) On 31st December, 2021 shoes worth ₹ 3,20,000 were sent to Mohan Shoes for sale on consignment basis of which 25% shoes were unsold and lying with Mohan Shoes as on 31st March, 2022.**

**(ii) On 10th January, 2022, Tonk Tanner supplied shoes worth ₹ 4,50,000 to Shani Shoes and concurrently agrees to re-purchase the same goods on 11th April. 2022.**

**(iii) On 21st March, 2022 shoes worth ₹ 1,60,000 were sold to Shoe Shine but due to refurbishing of their showroom being underway, on their request, shoes were delivered on 12th April, 2022.**

**You are required to advise the accountant of Tonk Tanners when amount is to be recognised as revenue in 2021-2022 in above cases in the context of AS 9.** ***(MTP 5 Marks Mar'23, RTP May'21)***

**Answer 12**

**i. Shoes sent to Mohan Shoes (consignee) for consignment sale**

In case goods are sent for consignment sale, revenue is recognized when significant risks of ownership have passed from seller to the buyer.

In the given case, Mohan Shoes is the consignee i.e. an agent of Tonk Tanners and not the buyer. Therefore, the risk and reward is considered to vest with Tonk Tanners only till the time the sale is made to the third party by Mohan Shoes; although the goods are held by Mohan Shoes. Hence, in the year 2021-2022, the sale will be recognized for the amount of goods sold by Mohan Shoes to the third party i.e. for ₹ 3,20,000 x 75% = ₹ 2,40,000.

**ii. Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date**

For such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue and should not be recognized as revenue in the year 2021 -2022. Hence, sale of ₹ 4,50,000 to Shani Shoes should not be recognized as revenue.

**iii. Delivery is delayed at buyer's request**

On 21st March, 2022, if Shoe Shine takes title and accepts billing for the goods then it is implied that the sale is complete and all the risk and rewards of ownership has been transferred to the buyer. In case no significant uncertainty exists regarding the amount of consideration for sale, revenue shall be recognized in the year 2021 -2022 irrespective of the fact that the delivery is delayed on the request of Shoe Shine.

## Question 13

**Given the following information of Rainbow Ltd.**

**(i) On 15th November, goods worth ₹ 5,00,000 were sold on approval basis. The period of approval was 4 months after which they were considered sold. Buyer sent approval for 75% goods sold upto 31st January and no approval or disapproval received for the remaining goods till 31st March.**

**(ii) On 31st March, goods worth ₹ 2,40,000 were sold to Bright Ltd. but due to refurnishing of their show-room being underway, on their request, goods were delivered on 10th April.**

**(iii) Rainbow Ltd. supplied goods worth ₹ 6,00,000 to Shyam Ltd. and concurrently agrees to re-purchase the same goods on 14th April.**

**(iv) Dew Ltd, used certain assets of Rainbow Ltd. Rainbow Ltd. received ₹ 7.5 lakhs and ₹12 as interest and royalties respectively from Dew Ltd. during the year 2020 -21.**

**(v) On 25th December, goods of ₹ 4,00,000 were sent on consignment basis of which 40% of the goods unsold are lying with the consignee at the year-end on 31st March.**

**In each of the above cases, you are required to advise, with valid reasons, the amount to be recognized as revenue under the provisions of AS-9.** ***(PYP 5 Marks Dec'21)(MTP 5 Marks Sep'23, Dec'24)***

**Answer 13**

(i) As per AS 9 "Revenue Recognition", in case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting ₹ 5,00,000 as the time period for rejecting the goods had expired.

(ii) The sale is complete but delivery has been postponed at buyer's request. The entity should recognize the entire sale of ₹ 2,40,000 for the year ended 31st March.

(iii) Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date, such transactions that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognized as revenue. Hence no revenue to be recognized in the given case.

(iv) Revenue arising from the use by others of enterprise resources yielding interest and royalty should be recognized when no significant uncertainty as to measurability or collectability exists. The interest should be recognized on time proportion basis taking into account the amount outstanding and rate applicable. The royalty should be recognized on accrual basis in accordance with the terms of relevant agreement.

(v) 40% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for ₹ 2,40,000 (60% of ₹ 4,00,000). In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

**EXAM INSIGHTS:** Few examinees were not able to quantify the amount to be recognized as revenue under the provisions of AS 9 "Revenue Recognition" for the given situations.

## Question 14

**Fashion Limited is engaged in manufacturing of readymade garments. They provide you the following information on 31st March, 2021:**

**(i) On 15th January, 2021 garments worth Rs. 4,00,000 were sent to Anand on consignment basis of which 25% garments unsold were lying with Anand as on 31st March, 2021.**

**(ii) Garments worth Rs. 1,95,000 were sold to Shine boutique on 25th March, 2021 but at the request of Shine Boutique, these were delivered on 15th April, 2021.**

**(iii) On 1st November, 2020 garments worth Rs. 2,50,000 were sold on approval basis. The period of approval was 4 months after which they were considered sold. Buyer sent approval for 75% goods up to 31st December, 2020 and no approval or disapproval received for the remaining goods till 31st March, 2021.**

**You are required to advise the accountant of Fashion Limited, the amount to be recognized as revenue in above cases in the context of AS 9.**

***(MTP 5 Marks Nov'21, Oct'19, Aug'18, RTP Nov'18, RTP Nov'20) (PYP 5 Marks May'23)***

**Answer 14**

As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

(i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

**Case (I):** 25% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for Rs. 3,00,000 (75% of Rs. 4,00,000) for the year ended on 31.3.21. In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

**Case (ii):** The sale is complete but delivery has been postponed at buyer's request. Fashion Ltd. should recognize the entire sale of Rs.1,95,000 for the year ended 31st March, 2021.

**Case (iii):** In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting Rs. 2,50,000 as the time period for rejecting the goods had expired.

Thus total revenue amounting Rs. 7,45,000 (3,00,000+1,95,000+2,50,000) will be recognized for the year ended 31st March, 2021 in the books of Fashion Ltd.

**EXAM INSIGHTS:** Majority examinees were able to ascertain the correct amount of revenue to be recognized in all the three situations given in the question as per AS 9 "Revenue recognition".

## Question 15

LDR

**Following information of BS Products Ltd. is given:**

I. **Goods of ₹ 2,00,000 sold to Den Ltd. on 20-03-2023 but at the request of the buyer these were delivered on 10-04-2023. ·**

II. **On 15-01-2023 goods of ₹ 3,00,000 were sent on consignment basis, of which 20% of the goods unsold are lying with the consignee as on 31-03-2023.**

III. **₹ 4,00,000 worth of goods were sold on approval basis on 01-12-2022. The period of approval was 3 months after which they were considered as sold. Buyer sent approval for 75% goods upto 31-01-2023 and no approval or disapproval received for the remaining goods till 31-03-2023.**

IV. **Apart from the above, BS Products Ltd. sells goods to dealers also. One of the condition of sale is that interest is payable @ 2% p.m. for delayed payments by dealers. Percentage of interest recovery is only 10% i.e. ₹ 50,000 on such overdue outstanding due to various reasons. During the year 2022-23, company wants to recognize the entire interest receivable of ₹ 60,000.**

**You are required to advise the accountant of BS Products Ltd., with valid reasons, the amount to be recognized as revenue in above cases in the context of AS-9 and also determine the total revenue to be recognized for the year ending 31-03-2023.** ***(RTP May'24) (RTP May'20) (Same concept different figures MTP 5 Marks Oct'22, PYP 5 Marks May'19, SM) (RTP Nov'23) (SM)***

**Answer 15**

I. the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

II. no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

**Case (i)**

The sale is complete but delivery has been postponed at buyer's request. BS Products Ltd. should recognize the entire sale of ₹ 2,00,000 for the year ended 31st March, 2023.

**Case (ii)**

20% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for ₹2,40,000 (80% of ₹ 3,00,000). In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

**Case (iii)**

In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the total sales amounting ₹ 4,00,000 as the time period for rejecting the goods had expired.

**Case (iv)**

As per the standard, "where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty involved. In such cases, the revenue is recognized only when it is reasonably certain that the ultimate collection will be made". In this case, interest should be recognized only if the ultimate collection is certain and the company expects to realize interest for the delayed payments for ₹ 50,000 only. Hence, based on the past experience, the realization of interest for the delayed payments by the agent is certain only to the extent of this amount and not ₹ 60,000. Therefore, the interest income of ₹ 50,000 should be recognized in the books for the year ended 31st March, 2023.

**Thus total revenue amounting ₹ 8,90,000 (2,00,000 + 2,40,000 + 4,00,000 + 50,000) will be recognized for the year ended 31st March, 2023 in the books of BS Products Ltd.**

## Question 16

**Indicate in each case whether revenue can be recognized and when it will be recognized as per AS-9.**

**(1) Trade discount and volume rebate received.**

**(2) Where goods are sold to distributors or others for resale.**

**(3) Where seller concurrently agrees to repurchase the same goods at a later date.**

**(4) Insurance agency commission for rendering services.**

**(5) On 11-03-2024 cloths worth ₹ 50,000 were sold to X mart, but due to refurbishing of their showroom being underway, on their request, clothes were delivered on 12-04-2024.** ***(MTP 4 Marks Nov'24)***

**Answer 16**

(1) Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

(2) When goods are sold to distributor or others, revenue from such sales can generally be recognized if significant risks of ownership have passed; however, in some situations the buyer may in substance be an agent and in such cases the sale should be treated as a consignment sale.

(3) For transactions, where seller concurrently agrees to repurchase the same goods at a later date that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognized as revenue.

(4) Insurance agency commissions should be recognized on the effective commencement or renewal dates of the related policies.

(5) On 11.03.2024, if X mart takes title and accepts billing for the goods then it is implied that the sale is complete and all risk and reward on ownership has been transferred to the buyers.

Revenue should be recognized for year ended 31$^{st}$ March, 2024 notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made and items were ready for delivery to the buyer at the time.



### Multiple Choice Questions (MCQs)

**1. Which of the conditions mentioned below must be met to recognize revenuefrom the sale of goods?**

**(i) the entity selling does not retain any continuing influence or controlover the goods;**

**(ii) when the goods are dispatched to the buyer;**

**(iii) revenue can be measured reliably;**

**(iv) the supplier is paid for the goods;**

**(v) it is reasonably certain that the buyer will pay for the goods;**

**(vi) the buyer has paid for the goods.** ***(SM)***

(a) (i), (ii) and (v)

(b) (ii), (iii) and (iv)

(c) (i), (iii) and (v)

(d) (i), (iv) and (v)

**Ans: (a)**

**2. Consignment inventory is an arrangement whereby inventory is held by one party but owned by another party. Which of the following indicates that the inventory in question is a consignment inventory?** ***(SM)***

(a) Manufacturer cannot require the dealer to return the inventory

(b) Dealer has the right to return the inventory

(c) Manufacture is responsible for the pricing of goods and any changes inthe pricing can only be approved by the manufacturer.

(d) Manufacture is responsible for the holding the goods and any changesin the pricing can only be approved by the dealer

**Ans: (c)**

3. **Which of the following transactions qualify as revenue for M/s AB Enterprises? *(SM)***
   (a) Sales of ₹ 20 lakhs made under consignment sales.
   (b) Sale of an old machine amounting ₹ 5 lakhs
   (c) Services provided to the customer in the normal course of business. Sales recorded is ₹ 50,000.
   (d) Sales of ₹ 25 lakhs made under consignment sales

**Ans: (c)**

4. **The Accounting Club has 100 members who are required to pay an annual membership fee of ₹ 5,000 each. During the current year, all members have paid the fee. However, 5 members have paid an amount of ₹ 10,000 each. Of these, 3 members paid the current year's fee and also the previous year's dues. Remaining 2 members have paid next years' fee of ₹ 5,000 in advance.**
   **Revenue from membership fee for the current year to be recognised will be: *(SM)***
   (a) ₹ 5,25,000
   (b) ₹ 5,10,000
   (c) ₹ 5,00,000
   (d) ₹ 5,15,000

**Ans: (c)**

5. **FlixNet International offers a subscription fee model to allow the paid subscribers an annual viewing of movies, sports events and other content. It allows users to register for free and have access to limited content for one month without any charges. The customer has a right to cancel the subscription within a month's time but is required to pay for 1 year subscription fee after the free period.**
   **XY has subscribed for free viewing on 1st March 20X1. After 1 month, he has agreed to pay the annual membership and has paid ₹ 1,200 on 31st March 20X1 for the subscription that is valid up to 31st of March 20X2.**
   **Revenue that can be recognized by FlixNet for the year ended 31st March 20X2 is *(SM)***
   (a) ₹ 100
   (b) ₹ 1,200
   (c) Nil
   (d) ₹ 1,100

**Ans: (b)**



6. **Sahil Ltd agreed to sell its factory located in Assam to Kali Ltd on 4.12.2023. It entered into a sale deed (transferring all significant risks and rewards of ownership) on 1.2.2024. But the transaction was registered with the registrar on 30.5.2024 When should the sale and gain be recognized? *(MTP 2 Marks Apr'24)***
   (a) Both sale and gain should be recognized as on the balance sheet date i.e. 31.3.2024.
   (b) Both sale and gain should be recognized on 30.5.2024.
   (c) The sale should be recognized as on balance sheet date but gain should be recognized on 30.5.2024.
   (d) Both sale and gain should be recognized on 4.12.2023.

**Ans: (a)**

7. **On 31st March 2024, Sri Radhey shyam Enterprise finds that the cost of a partly finished unit on that date is ₹ 530. The unit can be finished in 2024-25 by an additional expenditure of ₹ 310. The finished unit can be sold for ₹ 750 subject to payment of 8% brokerage on the selling price.**
   **Sri Radhey shyam Enterprise seeks your advice regarding the amount at which the unfinished unit should be valued as at 31st March, 2024 for preparation of final accounts. the partly finished unit cannot be sold in semi- finished form and its NRV is zero without processing it further. *(MTP 2 Marks Dec'24)***
   (a) ₹ 470
   (b) ₹ 380
   (c) ₹ 500
   (d) ₹ 440

**Ans: (b)**

B

# CHAPTER 9.1: AS 12 "ACCOUNTING FOR GOVERNMENT GRANTS"

**CONCEPTS OF THIS CHAPTER**

- Accounting treatment of government grants
- Capital vs. income approach
- Recognition of government grants
- Non-monetary government grants
- Refund of government grants
- Grant disclosures
- Grant presentation- Revenue, Fixed assets & Promoters' contribution

**LDR Questions**
**Q 18**

## QUICK REVIEW OF IMPORTANT CONCEPTS

### Two approaches

| | | |
|---|---|---|
| **'Capital approach'** | Grant is treated as part of shareholders' funds | Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds |
| **'Income approach'** | Grant is taken to income over one or more periods | Income approach may be more appropriate in the case of other grants |

### Presentation of Grants

**Related to Specific Fixed Assets**

| Method I : | Method II: |
|---|---|
| • The grant is shown as a deduction from the Gross value of the asset concerned in arriving at its book value. | • Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset |
| • The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. | • Grants related to non-depreciable assets are credited to capital reserve as there is usually no charge to income in respect of such assets. |
| • Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value. | • If a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income |

**Refund of Govt Grant related to Specific Fixed Assets**

- Is recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable
- In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

**Related to Revenue**

- Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

**Refund of Govt Grant related to Revenue**

| | | |
|---|---|---|
| • is applied first against any unamortised deferred credit remaining in respect of the grant | • To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, | • the amount is charged immediately to profit and loss statement |

**In nature of Promoters' Contribution**

- Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

**Refund of Govt Grant in the nature of promoters' contribution**

- Refundable, in part or in full, to the government on non-fulfilment of some specified conditions, the relevant amount recoverable by the government is Reduced from the capital reserve.

**Disclosure**

- The accounting policy adopted for government grants, including the methods of presentation in the financial statements
- The nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

## Question & Answers

### Question 1

**S Ltd. has received a grant of 18 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed 12 crores as dividend. Also, S 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. *(RTP Nov'23)***

**Answer 1**

As per AS 12, when government grant is received for a specific purpose, it should be utilized for the same.
Thus, the grant received for setting up a factory is not available for distribution of dividend.
As per AS-12, if an asset is acquired free of cost it is to be recorded at a nominal value.
Thus, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value.
The treatment of both the elements of the grant is incorrect as per AS 12.

### Question 2

**Viva Ltd. received a specific grant of ₹ 30 lakhs for acquiring the plant of ₹ 150 lakhs during 2018-19 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet and was not deducted from the cost of plant. During 2021-22, 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. 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 2021-22 in profit and loss account? *(MTP 5 Marks, Sep'22, May'20 & Mar'21, RTP May'19)***

**Answer 2**

As per 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. 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 2021-22. 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.

### Question 3

**Energy Ltd. has acquired a generator on 1.4.2023 for ₹ 100 lakh. On 2.4.2023, it applied to Indian Renewal Energy Development Authority (IREDA) for a subsidy. The subsidy was granted in June, 2024 after the accounts for 2023-2024 were finalized. The company has not accounted for the subsidy for the year ended 31.3.2024. State**

**(i) Is this a prior period item?**

**(ii) How should the subsidy be accounted in the accounting year 2024-2025?** ***(RTP Sep'24)***

**Answer 3**

(i) Whether a subsidy applied is to be classified as prior period item as per AS 5, depends upon whether the company has committed an error in 2023-2024 by not recognizing the subsidy?

The answer is in para 13 of AS 12 "Accounting for Government Grants" which permits recognition of grant only when there is reasonable assurance that -

(i) the enterprise will comply with the conditions attached to them and

(ii) the subsidy will be received.

Mere making of an application does not provide the reasonable assurance that the subsidy will be received. Letter of sanction from IREDA is required to provide this assurance. Since, the subsidy was granted in June, 2024 after approval of accounts, non-recognition of grant in 2023-2024 will not be considered as an error. Hence, this is not a prior period item. Therefore, the company was right in not recognizing the grant.

Further, AS 4 requires adjustment of events occurring after the balance sheet date only upto the date of approval of accounts by the Board of Directors. In view of this, the company is correct in not adjusting the same in the accounts in the year 2023-2024.

(ii) The subsidy should be deducted from the cost of the generator. The revised unamortised amount of generator should be written off over the remaining useful life.

Alternatively, the same may be treated as 'deferred income' and allocated over the remaining useful life in the proportion in which depreciation is charged.

## Question 4

**D Ltd. acquired a machine on 01-04-2017 for ₹ 20,00,000. The useful life is 5 years. The company had applied on 01-04-2017, for a subsidy to the tune of 80% of the cost. The sanction letter for subsidy was received in November 2020. The Company's Fixed Assets Account for the financial year 2020-21 shows a credit balance as under:**

| Particulars | ₹ |
|---|---|
| Machine (Original Cost) | 20,00,000 |
| Less: Accumulated Depreciation (from 2017-18- to 2019-20 on Straight Line Method) | 12,00,000 |
| | 8,00,000 |
| Less: Grant received | (16,00,000) |
| Balance | (8,00,000) |

**You are required to explain how should the company deal with this asset in its accounts for 2020-21?** ***(MTP 5 Marks Mar'23) (RTP Nov'21, May'18)***

**Answer 4**

From the above account, it is inferred that the Company has deducted grant from the book value of asset for accounting of Government Grants. Accordingly, out of the ₹ 16,00,000 that has been received, ₹ 8,00,000 (being the balance in Machinery A/c) should be credited to the machinery A/c. The balance ₹ 8,00,000 may be credited to P&L A/c, since already the cost of the asset to the tune of ₹ 12,00,000 had been debited to P&L A/c in the earlier years by way of depreciation charge, and ₹ 8,00,000 transferred to P&L A/c now would be partial recovery of that cost.

There is no need to provide depreciation for 2020-21 or 2021-22 as the depreciable amount is now Nil.

## Question 5

**A fixed asset is purchased for ₹ 30 lakhs. Government grant received towards it is ₹ 12 lakhs. Residual Value is ₹ 6 lakhs and useful life is 4 years. The company charges depreciation based on Straight-Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of ₹ 7.5 lakhs due to non-compliance with certain conditions. You are required to give necessary journal entries for second year.** ***(RTP May'22)***

**Answer 5**

**Journal Entries**

| Year | Particulars | | ₹ in lakhs (Dr.) | ₹ in lakhs (Cr.) |
|---|---|---|---|---|
| 2nd | Fixed Asset Account | Dr. | 7.5 | |
| | To Bank Account | | | 7.5 |
| | (Being government grant on asset partly refunded which increased the cost of fixed asset) | | | |
| | Depreciation Account (W.N.) | Dr. | 5.5 | |
| | To Fixed Asset Account | | | 5.5 |
| | (Being depreciation charged on SLM on revised value of fixed asset prospectively) | | | |
| | Profit & Loss Account | Dr. | 5.5 | |
| | To Depreciation Account<br>(Being depreciation transferred to Profit and Loss Account at the end of year 2) | | | 5.5 |

Working Note:

**Depreciation for Year 2**

| | ₹ in lakhs |
|---|---|
| Cost of the Asset | 30 |
| Less: Government grant received | (12) |
| Less: Depreciation for the first year [ 18-6 / 4] | 18 |
| | 3 |
| | 15 |
| Add: Government grant refundable | 7.5 |
| Depreciation for the second year [22.5-6 / 3] | 22.5 |



## Question 6

**Caseworker Limited received a specific grant of ₹ 6 crore for acquiring the plant of ₹ 30 crore on 1.4.2016 having useful life of 10 years. At the beginning of the financial year 2021-2022, due to non-compliance of conditions laid down for the grant of ₹ 6 crore, the company had to refund the grant to the Government. What should be the treatment of the refund if grant was deducted from the cost of the plant during financial year 2016-2017? Assume depreciation is charged on fixed assets as per Straight Line Method. *(MTP 5 Marks Apr'23 & Nov'21)***

**Answer 6**

As per AS 12, the amount refundable in respect of grant related to specific fixed assets 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. 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.

Where grant was deducted from the cost of the asset, initial value of the plant after deduction of grant amount of Rs. 6 crore would have been = Rs. 30 crore — Rs. 6 crore = Rs. 24 crore.

Carrying value of the plant after 5 years on 1.4.2021 = [(Rs. 24 crore / 10 years) x 5 years] = Rs. 12 crore. Annual depreciation charge would be Rs. 2.4 crore.

On refund of grant to the Government, the book value of the plant shall be increased by Rs. 6 crore i.e. Rs. 12 crore + Rs. 6 crore = Rs. 18 crore. The increased cost of Rs. 18 crore of the plant should be amortised prospectively over remaining 5 years of useful residual life. Depreciation charge in the year 2021-2022 would be Rs. 18 crore 15 years = Rs. 3.6 crore instead of earlier Rs. 2.4 crore.

## Question 7

**Darshan Ltd. purchased a Machinery on 1st April, 2016 for ₹ 130 lakhs (Useful life is 4 years). Government grant received is ₹ 40 lakhs for the purchase of above Machinery.**
**Salvage value at the end of useful life is estimated at ₹ 60 lakhs.**

Darshan Ltd. decides to treat the grant as deferred income.
Your are required to calculate the amount of depreciation and grant to be recognized in profit & loss account for the year ending 31st March, 2017,31st March, 2018, 31st March, 2019 & 31st March, 2020.
Darshan Ltd. follows straight line method for charging depreciation.
*(MTP 5 Marks Oct'21, PYP 5 Marks Jan'21)*

**Answer 7**

As per 12 "Accounting for government grants", grants related to depreciable assets, if treated as deferred income are recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Amount of depreciation and grant to be recognized in the profit and loss account each year

**Depreciation per year:**

| | ₹ in lakhs |
|---|---|
| Cost of the Asset | 130 |
| Less: Salvage value | (60) |
| | 70 |
| ciation per year (70lakhs / 4) | 17.50 |

₹ 17.50 Lakhs depreciation will be recognized for the year ending 31st March, 2017, 31st March, 2018, 31st March, 2019 and 31st March, 2020.

Amount of grant recognized in Profit and Loss account each year:

40 lakhs /4 years = ₹ 10 Lakhs for the year ending 31st March, 2017, 31st March, 2018, 31st March, 2019 and 31st March, 2020.

## Question 8

**Samrat Limited has set up its business in a designated backward area which entitles the company for subsidy of 25% of the total investment from Government of India. The company has invested Rs.80 crores in the eligible investments. The company is eligible for the subsidy and has received Rs.20 crores from the government in February 2019. The company wants to recognize the said subsidy as its income to improve the bottom line of the company.**

**Do you approve the action of the company in accordance with the Accounting Standard?**
***(RTP Nov'19, Nov'22)***



**Answer 8**

As per AS 12 "Accounting for Government Grants", where the government grants are in the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, Central Investment Subsidy Scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. The subsidy received by Samrat Ltd. for setting up its business in a designated backward area will be treated as grant by the government in the nature of promoter's contribution as the grant is given with reference to the total investment in an undertaking i.e. subsidy is 25% of the eligible investment and also no repayment is apparently expected in respect thereof. US $ 8,547 = 5,00,000/58.50 Since the subsidy received is neither in relation to specific fixed assets nor in relation to revenue. Thus, the company cannot recognize the said subsidy as income in its financial statements in the given case. It should be recognized as capital reserve which can be neither distributed as dividend nor considered as deferred income.

## Question 9

**Alps Limited has received the following Grants from the Government during the year ended 31st March, 2021:**

**(i) ₹ 120 Lacs received as Subsidy from the Central Government for setting up an Industrial undertaking in Medak, a notified backward area.**

**(ii) ₹ 15 Lacs Grant received from the Central Government on installation of Effluent Treatment Plant.**

**(iii) ₹ 25 Lacs received from State Government for providing Medical facilities to its workmen during the pandemic.**

**Advise Alps Limited on the treatment of the above Grants in its books of Account in accordance with AS-12 "Government Grants". *(PYP Jul'21, 5 Marks)***

**Answer 9**

**(i)** As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outly and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up an industrial undertaking in Medak is neither in relation to specific fixed asset nor in relation in revenue. Thus, the amount of ₹ 120 Lacs should be credited to capital reserve.

(Note: Subsidy for setting up an industrial undertaking is considered to be in the nature of promoter's contribution)

**(ii)** As per AS 12 'Accounting for Government Grants', two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives –

**(a)** The grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

**(b)** Grants related to depreciable asset are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

**(iii)** In the given case, ₹ 15 Lacs was received as grant from the Central Government for installation of Effluent Treatment Plant. Since the grant was received for a fixed asset, either of the above methods can be adopted.

**(iv)** ₹ 25 lacs received from State Government for providing medical facilities to its workmen during the pandemic is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as "Other Income". Alternatively, ₹ 25 lacs may be deducted in reporting the related expense i.e., employee benefit expense.

**EXAM INSIGHTS:** Majority of the examinees failed to explain the treatment of the grant in the given situations as per the provisions of AS 12.

## Question 10

**Ram Ltd. purchased machinery for Rs. 80 lakhs (useful life 4 years and residual value Rs. 8 lakhs). Government grant received was Rs. 32 lakhs. The grant had to be refunded at the beginning of third year. Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets in the third year and the amount of depreciation for remaining two years, if the grant had been credited to Deferred Grant A/c.** ***(MTP 5 Marks Apr'21, Apr'19, Apr'22 & Oct'23, MTP 7 Marks Aug'24)***

**Answer 10**

As per AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first two years (Rs. 32 lakhs /4 years) = Rs. 8 lakhs x 2 years= Rs. 16 lakhs will be credited to Profit and Loss Account and Rs. 16 lakhs will be the balance of Deferred Grant Account after two years. Therefore, on refund of grant, following entry will be passed:

| | | Rs. | Rs. |
|---|---|---|---|
| Deferred Grant A/c | Dr. | 16 lakhs | |
| Profit & Loss A/c | Dr. | 16 lakhs | |
| To Bank A/c | | | 32 lakhs |
| (Being Government grant refunded) | | | |

1. **Value of Fixed Assets after two years but before refund of grant**
   Fixed assets initially recorded in the books = Rs. 80 lakhs
   Depreciation for each year = (Rs. 80 lakhs – Rs.8 lakhs)/4 years = Rs. 18 lakhs per year
   Book value of fixed assets after two years = Rs. 80 lakhs – (Rs. 18 lakhs x 2 years) = Rs. 44 lakhs
2. **Value of Fixed Assets after refund of grant**
   On refund of grant the balance of deferred grant account will become nil. The fixed assets will continue to be shown in the books at Rs. 44 lakhs.
3. **Amount of depreciation for remaining two years**
   Depreciation will continue to be charged at Rs. 18 lakhs per annum for the remaining two years.

## Question 11

**Ram Ltd. purchased machinery for Rs. 80 lakhs (useful life 4 years and residual value Rs. 8 lakhs). Government grant received was Rs. 32 lakhs. The grant had to be refunded at the beginning of third year. Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets in the third year and the amount of depreciation for remaining two years, if the grant had been credited to Deferred Grant A/c. *(MTP 5 Marks Apr'21, Apr'19, Apr'22 & Oct'23, MTP 7 Marks Aug'24)***

**Answer 11**

As per AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first two years (Rs. 32 lakhs /4 years) = Rs. 8 lakhs x 2 years= Rs. 16 lakhs will be credited to Profit and Loss Account and Rs. 16 lakhs will be the balance of Deferred Grant Account after two years. Therefore, on refund of grant, following entry will be passed:

| | | Rs. | Rs. |
|---|---|---|---|
| Deferred Grant A/c | Dr. | 16 lakhs | |
| Profit & Loss A/c | Dr. | 16 lakhs | |
| To Bank A/c | | | 32 lakhs |
| (Being Government grant refunded) | | | |

1. **Value of Fixed Assets after two years but before refund of grant**
   Fixed assets initially recorded in the books = Rs. 80 lakhs
   Depreciation for each year = (Rs. 80 lakhs – Rs.8 lakhs)/4 years = Rs. 18 lakhs per year
   Book value of fixed assets after two years = Rs. 80 lakhs – (Rs. 18 lakhs x 2 years) = Rs. 44 lakhs
2. **Value of Fixed Assets after refund of grant**
   On refund of grant the balance of deferred grant account will become nil. The fixed assets will continue to be shown in the books at Rs. 44 lakhs.
3. **Amount of depreciation for remaining two years**
   Depreciation will continue to be charged at Rs. 18 lakhs per annum for the remaining two years.

## Question 12

**On 01.04.2018, Vivitzu Ltd. received Government grant of ₹ 100 Lakhs for an acquisition of new machinery costing ₹ 500 lakhs. The grant was received and credited to the cost of the assets. The life span of the machinery is 5 years. The machinery is depreciated at 20% on WDV method. The company had to refund the entire grant in 2nd April, 2021 due to non-fulfilment of certain conditions which was imposed by the government at the time of approval of grant. How do you deal with the refund of grant to the Government in the books of Vivitzu Ltd. as per AS 12? *(MTP 5 Marks, Mar'22, MTP 5 Marks Oct'20) (PYP 5 Marks May'18 & Nov'20)***

**Answer 12**

According to AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset (if the grant had been credited to the cost of fixed asset at the time of receipt of grant) should be recorded by increasing the book value of the asset, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

| | | (₹ in lakhs) |
|---|---|---|
| 1st April, 2018 | Acquisition cost of machinery (₹ 500 – ₹ 100) | 400.00 |
| 31st March, 2019 | Less: Depreciation @ 20% | (80) |
| 1st April, 2019 | Book value | 320.00 |
| 31st March, 2020 | Less: Depreciation @ 20% | (64) |
| 1st April, 2020 | Book value | 256.00 |
| 31st March, 2021 | Less: Depreciation @ 20% | (51.20) |
| 1st April, 2021 | Book value | 204.80 |
| 2nd April, 2021 | Add: Refund of grant | 100.00 |
| | Revised book value | 304.80 |

Depreciation @ 20% on the revised book value amounting ₹ 304.80 lakhs is to be provided prospectively over the residual useful life of the asset.

## Question 13

**Answer the following Questions:**

**Suraj Limited provides you the following information:**

(i) **It received a Government Grant @40% towards the acquisition of Machinery worth ₹ 25 Crores.**

(ii) **It received a Capital Subsidy of ₹ 150 Lakhs from Government for setting up a Plant costing ₹ 300 Lakhs in a notified backward region.**

(iii) **It received ₹ 50 Lakhs from Government for setting up a project for supply of arsenic free water in a notified area.**

(iv) **It received ₹ 5 Lakhs from the Local Authority for providing Corona Vaccine free of charge to its employees and their families.**

(v) **It also received a performance award of ₹ 500 Lakhs from Government with a condition of major renovation in the Power Plant within 3 years. Suraj Limited incurred 90% of amount towards Capital expenditure and balance for Revenue Expenditure.**

**State how you will treat the above in the books of Suraj Limited.** ***(PYP 5 Marks, May'22)***

**Answer 13**

(i) As per AS 12 "Accounting for Govt. Grants", two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under the first alternative, the grant of ₹ 10 crores (40% of 25 crores) is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognized the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Under second alternative method, grant amounting ₹ 10 crores is treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(ii) In the given case, the grant amounting ₹ 150 lakhs received from the Central Government for setting up a plant in notified backward area may be considered as in the nature of promoters' contribution. Thus, amount of ₹ 150 lakhs should be credited to capital reserve and the plant will be shown at ₹ 300 lakhs.

(iii) ₹ 50 lakhs received from Govt. for setting up a project for supply of arsenic free water in notified area should be credited to capital reserve. Alternatively, if it is assumed that the project consists of capital asset only, then the amount of ₹ 50 lakhs received from Govt. for setting up a project for supply of arsenic free water should either be deducted from cost of asset of the project concerned in the balance sheet or treated as deferred income which is recognized in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

(iv) ₹ 5 lakhs received from the local authority for providing corona vaccine to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss account, either separately or under a general heading 'Other Income'. Alternatively, ₹ 5 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

(v) ₹ 500 Lakhs will be reduced from the renovation cost of power plant or will be treated as deferred income irrespective of the expenditure done by the entity out of it as it was specifically received for the purpose major renovation of power plant. However, it may be, later on, decided by the Govt. whether the grant will have to be refunded or not due to non-compliance of conditions attached to the grant.

> **EXAM INSIGHTS:** Majority of the examinees were not able to explain the correct treatment of grant in line with the provisions of AS 12 "Accounting for Government Grant".

## Question 14

(i) **Hygiene Ltd. had received a grant of Rs. 50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. The company, however, failed to comply with the said conditions and consequently was required to refund the said amount in 2020. The company debited the said amount to its machinery account in 2020 on payment of the same. It also reworked the depreciation for the said machinery from the date of its purchase and passed necessary** adjusting entries in the year 2020 to incorporate the retrospective impact of the same. State whether the treatment done by the company is correct or not. (RTP May'21, May'23, New SM)

(ii) ABC Ltd. received two acres of land received for set up of plant. It also received Rs.2 lakhs received for purchase of machinery of Rs. 10 lakhs. Useful life of machinery is 5 years. Depreciation on this machinery is to be charged on straight-line basis. How should ABC Ltd. recognize these government grants in its books of accounts? *(RTP May'21)*

**Answer 14**

**(i)** As per the facts of the case, Hygiene Ltd. had received a grant of Rs.50 lakh in 2012 from a State Government towards installation of pollution control machinery on fulfilment of certain conditions. However, the amount of grant has to be refunded since it failed to comply with the prescribed conditions. In such circumstances, AS 12, "Accounting for Government Grants", requires that the amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. The Standard further makes it clear that in the first alternative, i.e., 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. Accordingly, the accounting treatment given by Hygiene Ltd. of increasing the value of the plant and machinery is quite proper. However, the accounting treatment in respect of depreciation given by the company of adjustment of depreciation with retrospective effect is improper and constitutes violation of AS 12.

**(ii) ABC Ltd. should recognize the grants in the following manner:**

- As per AS 12, government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value. Accordingly, land should be recognized at nominal value in the balance sheet.
- The standard provides option to treat the grant either as a deduction from the gross value of the asset or to treat it as deferred income as per provisions of the standard. Under first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Accordingly, the grant of Rs. 2 lakhs is deducted from the cost of the machinery. Machinery will be recognised in the books at Rs. 10 lakhs – Rs. 2 lakhs = Rs. 8 lakhs and depreciation will be charged on it as follows:

  Rs. 8 lakhs/ 5 years = Rs. 1.60 lakhs per year.

  Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Rs. 2 lakhs should be recognised as deferred income and will be transferred to profit and loss over the useful life of the asset. In this case, Rs. 40,000 [Rs. 2 lakhs / 5 years] should be credited to profit and loss each year over the period of 5 years.

## Question 15

**How would you treat the following in the accounts in accordance with AS 12 'Government Grants'?**

**(i) Rs.35 Lakhs received from the Local Authority for providing Medical facilities to the employees.**

**(ii) Rs.100 Lakhs received as Subsidy from the Central Government for setting up a unit in a notified backward area.**

**(iii) Rs.10 Lakhs Grant received from the Central Government on installation of anti- pollution equipment.**
***(RTP Nov'20, RTP May'20, MTP Oct'22, 5 Marks, Old & New SM)***

**Answer 15**

(i) Rs.35 lakhs received from the local authority for providing medical facilities to the employees is a grant received in the nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, Rs.35 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

(ii) As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of Rs.100 lakhs should be credited to capital reserve.

(iii) Rs.10 lakhs grant received for installation anti-pollution equipment is a grant related to specific fixed asset. Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives. Under first method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognized in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Under the second method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.
Thus, Rs.10 lakhs may either be deducted from the cost of equipment or treated as deferred income to be recognized on a systematic basis in profit & Loss A/c over the useful life of equipment.

## Question 16

**On 1st April, 2016, Mac Ltd. received a Government Grant of ₹ 60 lakhs for acquisition of machinery costing ₹ 300 lakhs. The grant was credited to the cost of the asset. The estimated useful life of the machinery is 10 years. The machinery is depreciated @ 10% on WDV basis. The company had to refund the grant in June 2019 due to non- compliance of certain conditions. How the refund of the grant is dealt with in the books of Mac Ltd. assuming that the company did not charge any depreciation for the year 2019-20. Pass necessary Journal Entries for the year 2019-20.**

***(PYP 5 Marks Nov'20) (Same concept different figures MTP 5 Marks, Mar'22, MTP 5 Marks Oct'20, PYP 5 Marks May'18)***

**Answer 16**

| | | **(₹ in lakhs)** |
|---|---|---|
| 1st April, 2016 | Acquisition cost of machinery Less: Government Grant | 300.00<br>60.00 |
| | | 240.00 |
| 31st March, 2017 | Less: Depreciation @ 10% | (24.00) |
| 1st April, 2017 | Book value | 216.00 |
| 31st March, 2018 | Less: Depreciation @ 10% | (21.60) |
| 1st April, 2018 | Book value | 194.40 |
| 31st March, 2019 | Less: Depreciation @ 10% | (19.44) |
| 1st April, 2019 | Book value<br>Less: Depreciation @10% for 2 months | 174.96<br>(2.916) |
| 1st June, 2019 | Book value | 172.044 |
| June 2019 | Add: Refund of grant* | 60.00 |
| | Revised book value | 232.044 |

Depreciation @10% on the revised book value amounting to ₹ 232.044 lakhs is to be provided prospectively over the residual useful life of the machinery.
*considered refund of grant at beginning of June month and depreciation for two months already charged. Alternative answer considering otherwise also possible.

**Journal Entries**

| | | | |
|---|---|---|---|
| Machinery Account | Dr. | 60 | |
| To Bank Account<br>(Being government grant on asset partly refunded which increased the cost of fixed asset) | | | 60 |
| Depreciation Account | Dr. | 19.337 | |
| To Machinery Account<br>(Being depreciation charged on revised value of fixed asset prospectively for 10 months) | | | 19.337 |
| Profit & Loss Account | Dr. | 22.253 | |

| | | | | |
|---|---|---|---|---|
| To Depreciation Account<br>(Being depreciation transferred to Profit and Loss Account amounting to ₹ (2.916 + 19.337= 22.253) | | | | 22.253 |

Question 17

**A Ltd. purchased a Machinery for ₹ 75 Lakhs. Government Grant received towards this Machinery is ₹ 10, Lakhs. Residual Value of Machinery at the end of useful life of 6 Years is ₹ 5 Lakhs.**
**Asset is shown in Balance Sheet at net of grant.**
**At the beginning of the 3rd year, an amount becomes refundable to the extent of ₹ 8 Lakhs due to non-compliance of certain conditions of grant.**
**You are required to give necessary Journal entries for the 1st year and the 3rd year in the books of A Ltd *(PYP 5 Marks Nov'23) (Same Concept Different Figure SM)***

**Answer 17**

**Journal Entries in the Books of A Ltd.**

| Year | Particulars | | ₹ in lakhs (Dr.) | ₹ in lakhs (Cr.) |
|---|---|---|---|---|
| 1 | Machinery Account | Dr. | 75 | |
| | To Bank Account | | | 75 |
| | (Being machinery purchased) | | | |
| | Bank Account | Dr. | 10 | |
| | To Machinery Account | | | 10 |
| | (Being grant received from the government reduced from the cost of machinery) | | | |
| | Depreciation Account (W.N.1) | Dr. | 10 | |
| | To Machinery Account | | | 10 |
| | (Being depreciation charged on Straight Line method (SLM)) | | | |
| | Profit & Loss Account | Dr. | 10 | |
| | To Depreciation Account | | | 10 |
| | (Being depreciation transferred to Profit and Loss Account at the end of year 1) | | | |
| 3 | Machinery Account | Dr. | 8 | |
| | To Bank Account | | | 8 |
| | (Being government grant on machinery partly refunded which increased the cost of fixed asset) | | | |
| | Depreciation Account (W.N.2) | Dr. | 12 | |
| | To Machinery Account | | | 12 |
| | (Being depreciation charged on SLM on revised value of fixed asset prospectively) | | | |
| | Profit & Loss Account | Dr. | 12 | |
| | To Depreciation Account | | | 12 |
| | (Being depreciation transferred to Profit and Loss Account at the end of year 3) | | | |

**Working Notes:**

1. **Depreciation for Year 1**

| | ₹ in lakhs |
|---|---|
| Cost of the Machinery | 75 |
| Less: Government grant received | (10) |
| | 65 |
| Depreciation $\left[\frac{65-5}{6}\right]$ | 10 |

2. **Depreciation for Year 3**

| | ₹ in lakhs |
|---|---|
| Cost of the Machinery | 75 |
| Less: Government grant received | (10) |
| | 65 |
| Less: Depreciation for the first two years | 20 |
| | 45 |
| Add: Government grant refundable | 8 |
| | 53 |
| Depreciation for the third year $\left[\frac{53-5}{4}\right]$ | 12 |

**EXAM INSIGHTS: Few** examinees could not calculate the depreciation to be charged to Profit & Loss Account for 1 and 3 years, resulting in incorrect journal entries.

## Question 18

LDR

**On 1st April 2021, Eleanor Limited purchased a manufacturing Plant for ₹ 60 lakhs, which has an estimated useful life of ₹ 10 years with a salvage value of ₹ 10 lakhs. On purchase of the Plant, a grant of ₹ 20 lakhs was received from the government.**

**You are required to calculate the amount of depreciation as per AS-12 for the financial year 2022-23 in the following cases:**

**(i) If the grant amount is deducted from the value of Plant.**

**(ii) If the grant is treated as deferred income.**

**(iii) If the grant amount is deducted from the value of Plant, but at the end of the year 2022-2023 grant is refunded to the extent of ₹ 4 lakhs, due to non-compliance of certain conditions.**

**(iv) If the grant is treated as the promoter's contribution.**

**(Assume depreciation on the basis of Straight-Line Method.)** ***(PYP 5 Marks May'23)***

**Answer 18**

Calculation of depreciation as per AS 12 for the financial year 2022-23:

(i) If the grant amount is deducted from the value of Plant, then the amount of deprecation will be ₹ 3,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) / 10 year.

(ii) If the grant is treated as deferred income, then amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 - ₹ 10,00,000) / 10 year.

(iii) If the grant amount is deducted from the value of plant, but at the end of the year 2022-23 grant is refunded to the extent of ₹ 4 lakh then the amount of depreciation will be ₹ 3,00,000 p.a.

(₹ 60,00,000 - ₹ 10,00,000 - ₹ 20,00,000) /10 year for year 202122 and for the year 2022-23 Depreciation will be ₹ 3,00,000 calculated as follows, (₹60,00,000 - ₹ 10,00,000 - ₹ 20,00,000– ₹ 3,00,000) / 10 years.

Note: It is assumed that the depreciation for the year has been charged on the book value on the plant before making adjustment for grant. Alternatively, if it is considered otherwise then the depreciation will be charged after making adjustment for grant. In that case depreciation for the year 2022-23 will be as ₹ 3,44,444 calculated as follows, (₹ 60,00,000 - ₹10,00,000 - ₹ 20,00,000 + 4,00,000– ₹ 3,00,000 / 9 years

(iv) If the grant is treated as promoter's contribution, then the amount of depreciation will be ₹ 5,00,000 p.a. (₹ 60,00,000 -10,00,000) /10 year.

**NOTE:** The answer can be presented in the following alternative manner:

| | | **(i)** | **(ii)** | **(iii)** | **(iv)** |
|---|---|---|---|---|---|
| **Date** | **Particulars** | **Grant Value deducted from Plant** | **Grant treated as Deferred Income** | **Grant Refunded** | **Grant is treated as Promoter's Contribution** |
| 01.04.2021 | Cost of Plant<br>Less: Salvage | 60,00,000<br>10,00,000 | 60,00,000<br>10,00,000 | 60,00,000<br>10,00,000 | 60,00,000<br>10,00,000 |
| | | **50,00,000** | **50,00,000** | **50,00,000** | **50,00,000** |
| 01.04.2021 | Less: Grant | 20,00,000 | - | 20,00,000 | - |

| | | | | | |
|---|---|---|---|---|---|
| | | 30,00,000 | 50,00,000 | 30,00,000 | 50,00,000 |
| | Useful Life (years) | 10 | 10 | 10 | 10 |
| 31.03.2022 | Depreciation FY 2021-22 | 3,00,000 | 5,00,000 | 3,00,000 | 5,00,000 |
| 1.4.2022 | Cost of Plant<br>Less: Salvage | | | 60,00,000<br>10,00,000 | |
| | | | | 50,00,000 | |
| | Less: Grant | | | 20,00,000 | |
| | Less: | | | 30,00,000 | |
| | Depreciation FY 2022-23 | | | 3,00,000 | |
| | | | | 27,00,000 | |
| | Book value at the time of refund of grant i.e. at the end of period | | | 4,00,000 | |
| | Add: Grant Refundable at end of 22-23 Book value available for remining 8 years. | | | 31,00,000 | |

**Note:**

It is assumed that the depreciation for the year has been charged on the book value on the plant before making adjustment for grant. Alternatively, if it is considered otherwise then the depreciation will be charged after making adjustment for grant. In that case depreciation for the year 2022-23 will be as:

| | |
|---|---|
| Cost of Plant | 60,00,000 |
| Less: Salvage | 10,00,000 |
| | 50,00,000 |
| Less: Grant | 20,00,000 |
| | 30,00,000 |
| Add: Grant Refundable | 4,00,000 |
| | 34,00,000 |
| Less: Depreciation For 2021-22 | 3,00,000 |
| | 31,00,000 |
| Useful Life (years) | 9 |
| Depreciation For 2022-23 | 3,44,444 |

**EXAM INSIGHTS:** Some of the examinees failed to calculate the amount of depreciation as per AS 12 "Accounting for Govt. Grants" for the financial year 2022-23 in the different cases.

## Multiple Choice Questions (MCQs)

1. **To encourage industrial promotion, IDCI offers subsidy worth Rs. 50 lakhs to all new industries set up in the specified industrial areas. This grant is in the nature of promoter's contribution. How such subsidy should be accounted in the books? *(SM)***
   (a) Credit it to capital reserve
   (b) Credit it as 'other income' in the profit and loss account in the year of commencement of commercial operations
   (c) Both (a) and (b) are permitted
   (d) Credit it to general reserve

**Ans: (a)**

**2. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be *(SM)***

(a) recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable as an ordinary item.

(b) recognised and disclosed in the Statement of Profit and Loss of the period in which the losses or expenses were incurred.

(c) recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item if appropriate as per AS 5.

(d) Disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item.

**Ans: (c)**

**3. Which of the following is an acceptable method of accounting presentation for a government grant relating to an asset? *(SM)***

(a) Credit the grant immediately to Income Statement

(b) Show the grant as part of Capital Reserve

(c) Reduce the grant from the cost of the asset or show it separately as a deferred income on the Liability side of the Balance Sheet.

(d) Show the grant as part of General Reserve

**Ans: (c)**

**4. X Ltd. has received a grant of ₹ 20 crore for purchase of a qualified machine costing ₹ 80 crore. X Ltd has a policy to recognize the grant as a deduction from the cost of the asset. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of annual depreciation to be charged as an expense in Profit and Loss Statement will be: *(SM)***

(a) ₹ 10 crore

(b) ₹ 6 crore

(c) ₹ 2 crore

(d) ₹ 8 crore

**Ans: (b)**

**5. X Ltd has received a grant of ₹ 20 crore for purchase of a qualified machine costing ₹ 80 crore. X Ltd. has a policy to recognise the grant as deferred income. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of other income to be to be recognized in the Profit and Loss Statement will be: *(SM)***

(a) ₹ 10 crore

(b) ₹ 6 crore

(c) ₹ 2 crore

(d) ₹ 8 crore

**Ans: (c)**

# CHAPTER 9.2: AS 14 "ACCOUNTING FOR AMALGAMATIONS"

**CONCEPTS OF THIS CHAPTER**

- Types of amalgamation
- Computation of purchase consideration
- Amalgamation post balance sheet date
- Accounting for amalgamation
- AS 14 disclosure requirements

**LDR Questions**
**Q 6**

## QUICK REVIEW OF IMPORTANT CONCEPTS

**Amalgamation may be either in the nature of**

| Merger | Purchase |
|---|---|
| **Method of Accounting - Pooling of Interest method** | **Method of Accounting - Purchase method** |
| Amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies ar amalgamations in the nature of merger. | Amalgamations which are in effect a mode by which one company acquires another company and as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or the business of the company which is acquired is not intended to be continued. |
| **Treatment of Reserves** | |
| Identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. | Identity of the reserves, other than the statutory reserves is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve. |
| **Balance of the Profit & Loss appearing in the Financial Statements of the transferor company** | |
| Is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any. | Debit or credit balance loses its identity |

### Conditions for Amalgamation in the nature of Merger and Purchase

- All assets and liabilities of the transferor company become those of the transferee company after amalgamation.
- At least 90% of transferor company shareholders (excluding pre-existing holdings of the transferee company or its subsidiaries) become equity shareholders of the transferee company.
- Consideration is fully paid in transferee company shares, except for cash on fractional shares.
- The transferee company continues the transferor company's business.
- No asset or liability adjustments are made, except for accounting policy alignment.

## Question & Answers

### Question 1

**Briefly explain the methods of accounting for amalgamation as per Accounting Standard-14. *(SM) (MTP 4 Marks Oct'23)***

**Answer 1**

As per AS 14 on 'Accounting for Amalgamations', there are two main methods of accounting for amalgamations:

The Pooling of Interest Method

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the necessary adjustments).

If at the time of amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.



### Question 2

**X Co. Ltd. having share capital of ₹ 50 lakhs divided into equity shares of ₹ 10 each was taken over by Y Co. Ltd. Y Co. Ltd. issued 11 equity shares of ₹ 10 each for every 10 shares of X Co. Ltd.**

**Explain how the difference will be adjusted in the books of Y Co. Ltd. for the shares issued under the 'Pooling of interests method' of amalgamation as per AS 14. *(SM)***

**Answer 2**

| **Particulars** | ₹ |
|---|---|
| Purchase consideration = 5,00,000 x 11/10 = 55,000 | 55,00,000 |
| shares of ₹ 10 each | 50,00,000 |
| Less: Share capital of X Co. Ltd. | |
| Difference Adjusted through General Reserve | 5,00,000 |

### Question 3

**Wiwitsu Ltd. is absorbed by Nistha Ltd.; the consideration being the takeover of liabilities, the payment of cost of absorption not exceeding ₹ 10,000 (actual cost ₹ 9,000); the payment of the 9% debentures of ₹ 50,000 at a premium of 20% through 8% debentures issued at a premium of 25% of face value and the payment of ₹15 per share in cash and allotment of three 11% preference shares of ₹ 10 each and four equity shares of ₹10 each at a premium of 20% fully paid for every five shares in Wiwitsu Ltd.**

**The number of shares of the vendor company are 1,50,000 of ₹ 10 each fully paid. Calculate purchase consideration as per AS 14. *(RTP Jan'25)***

**Answer 3**

As per AS 14 'Accounting for Amalgamations', the term 'consideration' has been defined as the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

The payment made by transferee company to discharge the Debenture holders and outside liabilities and cost of winding up of transferor company shall not be considered as part of purchase consideration.

**Computation of Purchase Consideration**

| | ₹ |
|---|---|
| Cash payment ₹ 15 x 1,50,000 | 22,50,000 |
| 11% Preference Shares of ₹ 10 each [(1,50,000 x 3/5) x ₹ 10] | 9,00,000 |
| Equity shares of ₹ 10 each @ 20% premium [(1,50,000 x 4/5) x ₹ 12] | 14,40,000 |
| Total Purchase consideration | 45,90,000 |

## Question 4

**On 1st April, 2018, Tina Ltd. take over the business of Rina Ltd. and discharged purchase consideration as follows:**

**(i) Issued 50,000 fully paid Equity shares of ₹ 10 each at a premium of ₹ 5 per share to the equity shareholders of Rina Ltd.**

**(ii) Cash payment of ₹ 50,000 was made to equity shareholders of Rina Ltd.**

**(iii) Issued 2,000 fully paid 12% Preference shares of ₹ 100 each at par to discharge the preference shareholders of Rina Ltd.**

**(iv) Debentures of Rina Ltd. 20,000) will he converted into equal number and amount of 10% debentures of Tina Ltd.**

**Calculate the amount of Purchase consideration as per AS-14 and pass Journal Entry relating to discharge of purchase consideration in the books of Tina Ltd. *(SM)***

**Answer 4**

As per AS 14, consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Computation of Purchase Consideration

| **Particulars** | ₹ |
|---|---|
| Equity Shares (50,000x 15) | 7,50,000 |
| Cash payment | 50,000 |
| 12% Preference Share Capital | 2,00,000 |
| Purchase Consideration | 10,00,000 |

Note: Payment to debenture holders are not covered by the term 'consideration'.

**Journal entry**

| **Particulars** | ₹ | ₹ |
|---|---|---|
| Liquidation of Rina Ltd. A/c | 10,00,000 | |
| To Equity share capital A/c | | 5,00,000 |
| To 12% Preference share capital A/c | | 2,00,000 |
| To Securities premium A/c | | 2,50,000 |
| To Bank/Cash A/c (Being payment of cash and issue of shares for discharge of purchase consideration) | | 50,000 |

## Question 5

**Wow Ltd. agreed to takeover Wonder Ltd. on 1st April 2024. The terms and conditions of takeover were as follows:**

**(i) Wow Ltd. issued 56,000 equity shares of ₹ 100 each at a premium of ₹ 15 per share to the equity shareholders of Wonder Ltd.**

**(ii) Cash payment of ₹ 9,000 was made to equity shareholders of Wonder Ltd.**

**(iii) 24,000 fully paid preference shares of ₹ 50 each issued at par to discharge the preference shareholders**

of Wonder Ltd.

(iv) The 8% Debentures of Wonder Ltd. (₹ 78,000) converted into equivalent value of 9% debentures in Wow Ltd.

(v) The actual cost of liquidation of Wonder Ltd. was ₹ 23,000. Liquidation cost is to be reimbursed by Wow Ltd. to the extent of ₹ 15,000.

You are required to:

(1) Calculate the amount of purchase consideration as per theprovisions of AS 14 and

(2) Pass Journal Entry relating to discharge of purchase considerationin books of Wow Ltd. *(MTP 4 Marks July'24)*

**Answer 5**

As per AS 14, 'Accounting for Amalgamations' consideration for the amalgamation means the aggregate of shares and other securities issued and payment made in form of cash or other assets by the transferee company to the shareholders of the transferor company.

| **(i) Computation of Purchase Consideration** | | |
|---|---|---|
| | | ₹ |
| (a) Preference Shares: ₹ 50 per share 24,000 Preference shares | | 12,00,000 |
| (b) Cash | | 39,000 |
| (c) Equity shares: 56,000 equity shares in Wow Ltd. @ ₹ 115 | | 64,40,000 |
| | | 76,79,000 |
| **(ii) Journal entry** | | |
| | ₹ | ₹ |
| Liquidator of Wonder Ltd. Dr. | 76,79,000 | |
| To Cash | | 39,000 |
| To Preference Share Capital A/c | | 12,00,000 |
| To Equity Share Capital A/c | | 56,00,000 |
| To Securities Premium A/c | | 8,40,000 |
| [56,000 x ₹ 15 (115-100)] | | |



## Question 6

LDR

Exe Ltd. acquires 70% of equity shares of Zed Ltd. as on 31st March, 2024 at a cost of ₹70 lakhs. The following information is available from the balance sheet of Zed Ltd. as on 31st March, 2024:

| Particulars | ₹ in lakhs |
|---|---|
| Property, plant and equipment | 120 |
| Investments | 55 |
| Current Assets | 70 |
| Loans & Advances | 15 |
| 15% Debentures | 90 |
| Current Liabilities | 50 |

The following revaluations have been agreed upon (not included in the above figures):

Property, plant and equipment — Up by 20%

Investments — Down by 10%

Zed Ltd. declared and paid dividend @ 20% on its equity shares as on 31st March, 2024 (Face value – ₹10 per share). Exe Ltd. purchased the shares of Zed Ltd. @ ₹ 20 per share.

Calculate the amount of goodwill/capital reserve on acquisition of shares of Zed Ltd. *(MTP 7 Marks Dec'24)*

**Answer 6**

**Cost of Control**

| Sr. No | Particulars | Computation | ₹ |
|---|---|---|---|
| A] | Cost of Investments | Given | 70,00,000 |

| | | | |
|---|---|---|---|
| | Less: Dividend out of Pre Acquisition Dividend | (3.5 Lacs × ₹10 (FV) × 20%) (No Shares = 70 Lacs/20= 3.5Lacs) | (7,00,000) |
| | | Subtotal A | 63,00,000 |
| B] | Share in Net Assets of Zed Ltd. | (1,38,50,000 × 70%) | 96,95,000 |
| C] | Goodwill / (Capital Reserve) | (A – B) | 33,95,000 |

**W.N. 1 : Calculation of Net Assets**

| Sr. No. | Particulars | ₹ |
|---|---|---|
| A] | Assets | |
| - | Property, Plant & Equipment (120+20%) | 1,44,00,000 |
| - | Investment (55 – 10%) | 49,50,000 |
| - | Current Assets | 70,00,000 |
| - | Loans & Advances | 15,00,000 |
| | Subtotal A | 2,78,50,000 |
| B] | Liabilities | |
| - | 15% Debentures | 90,00,000 |
| - | Current Liabilities | 50,00,000 |
| | Subtotal B | 1,40,00,000 |
| C] | Net Assets (A – B) | 1,38,50,000 |

**W.N. 2 : No of shares acquired**

$= \frac{\text{Cost of investment}}{\text{purchase price share}}$

$= \frac{70,00,000}{₹20 \text{ shares}}$ = **₹ 3,50,000 shares**

Revalued net assets of Zed Ltd. as on 31.03.2024

| Particulars | ₹ in lakhs | ₹ in lakhs |
|---|---|---|
| Property Plant & Equipment [120 × 120%] | | 144.0 |
| Investments [55 × 90%] | | 49.5 |
| Current Assets | | 70.0 |
| Loans & Advances | | 15.0 |
| Total Assets after revaluation | | 278.5 |
| Less: 15% Debentures | 90.0 | |
| Current Liabilities | 50.0 | (140.0) |
| Equity / Net Worth | | 138.50 |
| Exe Ltd.'s share of net assets (70% of 138.50) | | 96.95 |
| Exe Ltd.'s cost of acquisition of shares of Zed Ltd. (₹70 lakhs – 7 lakhs*) | | 63.00 |
| Capital Reserve | | 33.95 |

| | |
|---|---|
| *Total Cost of 70% Equity of Zed Ltd. | ₹70 lakhs |
| Purchase Price of each share | ₹20 |
| Number of shares purchases(70 lakhs/20) | 3.50 lakhs |
| Dividend @ 20% i.e. ₹2/share | ₹7 lakhs |

Since, dividend received is for pre-acquisition period, it has been reduced from the cost of investment in the subsidiary company.

## Multiple Choice Questions (MCQs)

**1. Which of the following statements is correct: *(SM)***

(a) In case of merger – ESH can be issued only equity shares as a part of Purchase consideration.
(b) In case of purchase – ESH can be issued Preference shares also as a part of Purchase consideration.
(c) Both (a) and (b) are correct.
(d) Both (a) and (b) are incorrect.

**Ans: (b)**

**2. State which statement is correct: *(SM)***

(a) In case of merger – assets and liabilities can only be taken over at book values.
(b) In case of purchase – assets and liabilities can be taken over at book values or agreed values.
(c) Both (a) and (b) are correct.
(d) Both (a) and (b) are incorrect.

**Ans: (c)**

**3. State which statement is correct: *(SM)***

(a) In case of merger – All Reserves and surplus of vendor company are taken over by Purchasing company.
(b) In case of Purchase – None of the Reserves and surplus of vendor company are taken over by Purchasing company.
(c) Both (a) and (b) are correct.
(d) Only (a) is correct.

**Ans: (d)**

**4. State which statement is correct: *(SM)***

(a) In case of merger – We use pooling of interest method for accounting.
(b) In case of Purchase We use purchase method or pooling of interest method depending upon whether it is take over at agreed values or book values.
(c) Both (a) and (b) are correct.
(d) Only (a) is correct.

**Ans: (d)**



**5. State which statement is incorrect: *(SM)***

(a) In case of merger – We can issue either preference shares or equity shares to PSH.
(b) In case of Purchase – We can issue either preference shares or equity shares to PSH.
(c) In case of merger – We can issue only preference shares to PSH.
(d) none of the above.

**Ans: (c)**